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# THE SUBCHAPTER C REVISION ACT OF 1985

A Final Report Prepared by the Staff

Submitted to the

COMMITTEE ON FINANCE
UNITED STATES SENATE

Bob Packwood, *Chairman*

MAY 1985

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# LETTER OF TRANSMITTAL

Hon. BOB PACKWOOD,
*Chairman, Senate Finance Committee.*

Hon. RUSSELL B. LONG,
*Ranking Minority Member,*
*Senate Finance Committee.*

DEAR MR. CHAIRMAN AND SENATOR LONG: I am pleased to forward to you the final report regarding Subchapter C of the Internal Revenue Code that has been prepared by the staff, for consideration by the Committee.

This report is in response to a request made by Chairman Dole in October, 1982, to study recent proposals involving Subchapter C. (Attached to this letter is a copy of the Press Release announcing the initiation of the study by Chairman Dole.) In September, 1983, a Preliminary Report prepared by the staff was filed with the Committee. Hearings on the recommendations contained in the Preliminary Report were held in October, 1983.

This final report, entitled the "Subchapter C Revision Act of 1985," contains a set of specific statutory recommendations that would make extensive modifications to Subchapter C of the Code, as well as certain corollary sections. The report is organized into three parts. Part One contains a General Explanation of the recommendations, including background and summary of the October, 1983, hearing, description of present law, reasons for change, summary of the recommendations, and general comments as to the reasoning behind certain of the principal proposals. Part Two contains the specific statutory recommendations in bill form. Part Three contains a Technical Explanation of the recommendations, with a number of examples.

This report completes the work of the staff on this study.

Respectfully submitted,

WILLIAM M. DIEFENDERFER,
*Chief of Staff.*

[Press Release Oct. 28, 1982]

## FINANCE COMMITTEE ANNOUNCES STUDY OF REFORM AND SIMPLIFICATION OF CORPORATE TAXATION

Senator Bod Dole, Chairman of the Senate Finance Committee, today announced that he has directed the Committee staff, with the assistance of the staff of the Joint Committee on Taxation, to study recent proposals to revise the treatment of corporate mergers, acquisitions, and dispositions, net operating losses, and related issues concerning the taxation of corporations and shareholders. A report is to be filed with the Committee not later than February 28, 1983.

"The recently passed Tax Equity and Fiscal Responsibility Act of 1982 makes major strides toward preventing unintended corporate tax benefits to be realized by aggressive tax planners. Under the leadership of Senator Danforth, several of the tax abuses in corporate mergers and acquisitions have been foreclosed," Senator Dole stated. "But there remains more to be done. I believe that sophisticated taxpayers are still able to obtain unintended benefits in certain complex corporate transactions. Moreover, the enormous complexity of the current corporate tax law puts unintended burdens on honest taxpayers. As part of the Finance Committee's ongoing simplification efforts, I have directed that recent proposals of the American Bar Association Tax Section and the American Law Institute relating to Subchapter C of the Internal Revenue Code be carefully examined."

Senator Dole noted that he expects the staff to look into a number of issues in addition to recent legislative recommendations, including the relationship between the tax-free incorporation provisions and the corporate reorganization provisions, the treatment of net operating losses in corporate acquisitions, and the definitions of debt and equity. "Given the scope of this project, it is premature to foreclose any areas of inquiry," Senator Dole added. Taxpayers who wish to submit recommendations or to call problems to the attention of the staff are requested to send written submissions by December 15, 1982 to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

The Finance Committee's simplification effort in conjunction with the Ways and Means Committee yielded the Installment Sales Revision Act in 1980 and the Subchapter S revision bill this year.

Senator Dole noted that he expected that Finance Committee hearings would be held early next year on simplification proposals relating to taxable and tax-free corporate acquisitions and dispositions, as well as other proposals relating to corporate taxation.

# CONTENTS

Page
Part One: General Explanation of Subchapter C Revision Act of 1985 1
I. Introduction 3
  A. Background 3
  B. Summary of hearing 5
    1. Proposals on acquisitions 5
    2. Repeal of General Utilities doctrine 6
    3. Relief from repeal of General Utilities doctrine 7
    4. Proposals relating to net operating losses 8
    5. Proposals relating to publicly traded limited partnerships 8
    6. General procedure for proceeding 9
II. Description of Current Law 9
  A. Incorporations and other transfers to controlled corporations 9
    1. General rules 9
    2. Control requirement 9
    3. Business purpose requirement 10
    4. Overlap between transfers to controlled corporations and acquisitive transactions 10
    5. Assumption of liabilities 11
    6. Treatment of securities and installment debt 11
  B. Tax-free reorganizations 11
    1. Introduction 11
    2. Acquisitive transactions described in section 368(a) 12
    3. Other transactions described in section 368(a) 13
    4. Ordering rules 14
    5. Use of stock of corporation in control of the acquiring corporation 15
    6. Nonstatutory requirements 15
    7. Step transaction doctrine 16
  C. Consequence of tax-free reorganization to corporations and shareholders 16
    1. Introduction 16
    2. Treatment of acquired and transferor corporations 17
    3. Treatment of acquiring corporation 18
    4. Treatment of shareholders 18
    5. Carryover of attributes 19
    6. Whipsaw 19
  D. Investment companies 20
    1. Transfers to investment comanies under section 351 20
    2. Investment company reorganizations 20
  E. Taxable acquisitions 21
    1. Taxable asset acquisitions 21
    2. Taxable stock acquisitions 22
  F. Liquidations 24
    1. Treatment of liquidating corporation 24
    2. Treatment of shareholders 24
    3. Liquidating sales by corporations acquired in a C reorganization 25
    4. Liquidation-reincorporations 26
  G. Collapsible corporations 26
  H. Distributions to shareholders 27
    1. Treatment of distributing corporation 27
    2. Treatment of shareholders 28
    3. Distributions of stock of controlled corporations 29
    4. Earnings and profits 29

Page

Part One—Continued

II. Description of Current Law—Continued

- I. Varying definitions of "control" ... 30
- J. Rules determining the basis of stock in subsidiary corporations-relationship of stock basis to subsidiary asset basis ... 30
- K. Treatment of foreign corporations ... 31
  - 1. Transfers of property outside the United States ... 31
  - 2. Gain from sale or exchange of stock in certain foreign corporations ... 32
- L. Limitations on net operating loss carryovers and other tax attributes ... 32
  - 1. Net operating loss deduction ... 32
  - 2. Carryovers to successor corporations ... 32
  - 3. Acquisitions to evade or avoid tax ... 32
  - 4. The Libson Shops doctrine ... 33
  - 5. Special limitations on NOL and other attributes ... 33
  - 6. Effect of section 269 and the Libson Shops doctrine ... 34
  - 7. Consolidated return regulations ... 34
  - 8. 1976 Act amendments ... 34
- M. Treatment of S corporations ... 35
- N. Treasury Department proposal for fundamental tax reform ... 36
  - 1. Dividends-paid deduction ... 36
  - 2. Large limited partnerships ... 36
  - 3. Repeal special reorganization rules ... 37
  - 4. Other ... 37

III. Reasons for change ... 37

- A. General reasons for change ... 37
- B. Detailed reasons for change ... 38
  - 1. Problems relating to the definition of "reorganzation" ... 38
  - 2. Problems presented by the General Utilities doctrine ... 42
  - 3. Problems relating to treatment of investors in a reorganization ... 44
  - 4. Discontinuities between stock and asset acquisitions ... 45
  - 5. Problems relating to transfers to controlled subsidiaries ... 46
  - 6. Differing definitions of "control" ... 47
  - 7. Problems relating to net operating loss carryover rules ... 47
  - 8. Problems relating to interaction between subchapter C and subchapter S ... 49
  - 9. Miscellaneous other problems ... 49

IV. Summary of Proposals ... 50

- A. Definition of qualified acquisition (new section 364 of the Code) ... 50
- B. Elective tax treatment of qualified acquisitions (new section 365 of the Code) ... 51
- C. Corporate level tax consequences of qualified acquisitions (sections 361, 362 and 381 of the Code) ... 51
- D. Shareholder level tax consequences of qualified acquisitions (sections 354, 356 and 359 of the Code) ... 52
- E. Tax consequences of distributions ... 53
  - 1. Corporate level tax consequences (section 311 of the Code) ... 53
  - 2. Shareholder level tax consequences (sections 331, 332, 333, 334, 354, 356 and new section 1060 of the Code) ... 53
- F. Basis in stock of controlled subsidiary (new section 1020 of the Code) ... 54
- G. Net operating loss carryovers (new sections 382, 382A, and 383 of the Code) ... 55
- H. Other principal changes ... 57
  - 1. Section 351 ... 57
  - 2. Sections 357 ... 57
  - 3. Section 1032 ... 57
  - 4. Section 1248 and new section 1257 ... 57
  - 5. Amendments to S corporation provisions (sections 1367 and 1368) ... 58

V. General comments ... 58

- A. Proposals relating to acquisitions ... 58
- B. Repeal of General Utilities doctrine ... 59
- C. Relief from repeal of General Utilities doctrine ... 62
  - 1. Eligible transactions ... 63
  - 2. Form of the relief ... 64

Page

Part One—Continued

V. General comments—Continued

D. Other forms of relief ..... 65

E. Net operating losses ..... 68

F. Publicly traded limited partnerships ..... 72

G. Further proceedings ..... 73

Part Two: Proposed statutory amendments ..... 75

Part Three: Technical Explanation of Subchapter C Revision Act of 1985 ..... 209

# PART ONE: GENERAL EXPLANATION OF SUBCHAPTER C REVISION ACT OF 1985

# GENERAL EXPLANATION OF SUBCHAPTER C REVISION ACT OF 1985

## I. INTRODUCTION

The "Subchapter C Revision Act of 1985," represents the culmination of a lengthy, comprehensive examination of the fundamental rules in the Internal Revenue Code relating to the Federal income taxation of corporations and their investors. Over the years, those rules have developed largely in a piecemeal fashion, as provisions have been added or modified to address specifically targeted problems or abuses. Taken together, however, the rules have often been criticized as inconsistent and unnecessarily complex, producing uncertain and, at times, capricious results in various transactions.

Despite these criticisms, over the last 50 years, Congress has not had occasion to provide a careful and thorough review of the rules as a whole, to determine whether a more cohensive, internally consistent set of rules could be developed in the area. This report, which proposes in bill form significant revisions to Subchapter C of Chapter 1 of the Internal Revenue Code, dealing generally with corporate distributions and adjustments, represents a first step towards providing that cohesive body of rules.

### *A. Background*

A number of thoughtful and extensive proposals have been made over the years by the organized tax bar and other interested parties to reform and rationalize the area of Subchapter C. For example, in 1958, the Subchapter C Advisory Group submitted a comprehensive set of recommendations to the House Ways and Means Committee to make significant revisions to Subchapter C.[1] Many of the problems identified in the Advisory Group's report still exist today, and certain of the proposals contained in this bill have their origins in that carefully crafted report.

More recently, in 1981, the American Bar Association's Tax Section published a number of significant recommendations concerning revisions to Subchapter C which resulted from an extended period of careful, deliberate examination of the problems in current law.[2] The principal thrust of the recommendations was to simplify and standardize the definition of "reorganization." Certain of the recommendations made by the Tax Section are contained in the present bill.[3]

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[1] "Revised Report of the Advisory Group on Subchapter C" (1958). The members of the Advisory Group included Norris Darrell, Chairman; C. Rudolf Peterson, Vice Chairman; Edwin S. Cohen, Counsel; and Marvin E. Collie, Kenneth W. Gemmill, Samuel J. Lanahan, and Leonard L. Silverstein, Advisory Group.

In 1982, the American Law Institute completed an eight-year study of Subchapter C and published a lengthy report containing extensive proposals to revise the statutory rules relating to the tax treatment of corporate acquisitions and dispositions.[4] Many of the recommendations made by the American Law Institute have served as the genesis for proposals contained in the present bill.

Other thoughtful recommendations that have been made include reports by the New York State Bar Association Tax Section,[5] the Tax Committee of the Association of the Bar of the City of New York,[6] the American Institute of Certified Public Accountants,[7] the special Task Force of ABA Section of Taxation,[8] and other professional groups and individuals.

On October 28, 1982, the Chairman of the Senate Finance Committee announced that he had directed the Committee staff, with the assistance of the staff of the Joint Committee on Taxation, to study recent proposals to revise the treatment of corporate mergers, acquisitions and dispositions, net operating losses, and related issues, and to report back to the Committee recommendations for changes where appropriate. A preliminary report [9] was filed with the Committee on September 22, 1983, and a hearing on the proposals contained in the report was held on October 24, 1983 (see below for summary of hearing).

Subsequent to the hearing, the staffs endeavored to restudy the proposals to take into account the testimony and submissions received as a result of the hearing, and to draft legislative language for use by the Committee. Certain of the proposals were enacted as part of the Deficit Reduction Act of 1984, P.L. 98-369 (see description of current law below). The remaining proposals, as modified, are set forth in the accompanying draft legislative language. A Technical Explanation of the bill is also included.

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[2] Committee on Corporate Shareholder Relationships, Tax Section Recommendation No. 1981-5, 34 Tax Lawyer 1386 (1981).

[3] Certain of the recommendations were also enacted in 1984 as part of the Deficit Reduction Act of 1984, P.L. 98-369.

[4] American Law Institute, *Federal Income Tax Project: Subchapter C* (1982).

[5] *See, e.g.*, New York State Bar Association Tax Section, "Report of the Committee on Corporations on Section 338" (1983); New York State Bar Association Tax Section Committee on Corporations, comments on 1984 Act provisions (April 26, 1984).

[6] *See, e.g.*, Association of the Bar of the City of New York, Committee on Taxation, comments on 1984 Act provisions (April 27, 1984); Association of the Bar of the City of New York, Committee on Taxation, comments on staff report of Senate Finance Committee (November 2, 1983) (hereinafter, "NYC Bar comments").

[7] Federal Tax Division of the American Institute of Certified Public Accountants, "Taxation of the Formation and Combination of Business Enterprises" (1979).

[8] ABA Section of Taxation Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock," 37 Tax Lawyer 625 (1984).

[9] Staff of the Senate Committee on Finance, "The Reform and Simplification of the Income Taxation of Corporations," 98th Cong., 1st Sess., S. Prt. No. 98-95 (Sept. 22, 1983) (hereinafter "Staff Report").

During the 2½ years that the staffs have undertaken this project, all of the submissions described above, as well as a number of thoughful suggestions and comments received from private practitioners and academicians, have been carefully reviewed and considered. The staffs have also met regularly with an outstanding group of tax practitioners and academicians and representatives of the Treasury Department, Internal Revenue Service, and other Congressional staffs, to discuss and review the proposals.[10]

### *B. Summary of hearing*

On October 24, 1983, a hearing was held on the proposals contained in the preliminary Staff Report on Subchapter C. A total of 22 witnesses testified at the hearing, including the Hon. Ronald A. Pearlman, then-Deputy Assistant Secretary (Tax Policy), Department of the Treasury, and representatives from the American Bar Association's Section of Taxation, the New York State Bar Association's Tax Section, and the Chicago Bar Association's Federal Taxation Committee. In addition, written submissions were received from 26 organizations and individuals.

A summary of the oral and written testimony presented in connection with the hearing is provided below.[11]

#### *1. Proposals on acquisitions*

Almost without exception, the principal changes recommended in the Staff Report relating to corporate mergers and acquisitions were favorably received. These included recommendations to permit explicit electivity of the tax consequences of the transaction, to make independent the tax consequences at the shareholder and corporate levels of an acquisition, and to permit shareholders receiving qualifying consideration to be entitled to nonrecognition of gain or loss treatment regardless of amount or type of consideration received by other shareholders.[12] For example, the Treasury

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[10] The outside tax practitioners and academicians who have met regularly with the staffs include Bernard Aidinoff, Donald Alexander, William Andrews, Frank Battle, Herbert Camp, N. Jerold Cohen, James Eustice, Peter Faber, Martin Ginsburg, Harold Handler, James Holden, Robert Jacobs, Howard Krane, Robert Lawrence, Richard May, Willard Taylor, and Mark Yecies. Fred Goldberg also participated prior to becoming Chief Counsel of the IRS.

[11] Testimony relating to proposals that were enacted as part of the Deficit Reduction Act of 1984, or that have been dropped from this bill, has generally been omitted.

[12] *See, e.g.*, Testimony of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury (hereinafter "Pearlman testimony"), at 13; Testimony of William D. Andrews (hereinafter "Andrews testimony") at 65-66, 69-70; Testimony of Willard B. Taylor on behalf of the Tax Section of the New York State Bar Association (hereinafter "Taylor testimony") at 99, 111-12; Testimony of Frank V. Battle, Jr. on behalf of the Special Committee on Subchapter C legislation, Federal Taxation Committee, Chicago Bar Association (hereinafter "Battle testimony") at 114, 117-18; Testimony of Donald C. Alexander (hereinafter "Alexander testimony") at 130; Testimony of Robert A. Jacobs (hereinafter "Jacobs testimony") at 137-40; Testimony of John S. Nolan (hereinafter "Nolan testimony") at 170-71; Testimony of Thomas P. Maletta on behalf of Tax Executives Institute, Inc. (hereinafter "Maletta testimony") at 188-89; Testimony of David A. Berenson (hereinafter "Berenson testimony") at 243; Testimony of James M. Roche (hereinafter "Roche testimony") at 280; Testimony of Deloitte Haskins and Sells (hereinafter "DHS testimony") at 457-58. All page references are to "Reform of Corporate Taxation,"

Continued

Department stated: "[the acquisitions] proposals have substantial merit in that they would provide greater consistency and symmetry to the tax treatment of corporate acquisitions." [13]

A number of individuals also testified in support of specific proposals contained in the acquisitions area. These included: (1) elimination of the current law rule contained in section 356(a) of the Code that limits dividend income to recognized gain;[14] (2) codification of the result in *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973;[15] (3) elimination of the judicially-created tests of continuity of interest, business purpose, and continuity of business enterprise;[16] (4) special rules for determining the basis of the stock of a controlled subsidiary;[17] (5) conformance of the treatment of securities in incorporation and acquisition transactions;[18] and (6) special treatment of unallocated purchase premium.[19]

### *Repeal of General Utilities doctrine*

A number of people also testified in favor of the proposed repeal of the doctrine which stems from the Supreme Court's decision in *General Utilities and Operating Company* v. *Helvering,* 296 U.S. 200 (1935).[20] Indeed, the Treasury Department indicated that its support for the acquisitions proposals in general was *premised* upon a repeal of *General Utilities.*[21] Others indicated that the symmetry created between basis step-up and gain recognition would greatly reduce complexity and would eliminate the "completely random results" that current law sometimes produces.[22]

Other people testified in opposition to the repeal of *General Utilities.*[23] In the vast majority of cases, the reason for the opposition was the concern that the repeal of *General Utilities* would result in a "double tax" on "largely inflationary" gains on long-held assets of small businesses.[24] Examples cited included the potentially ad-

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Hearing before the Committee on Finance, United States Senate, 98th Cong., 1st Sess. (October 24, 1983), S. Hrg. No. 98-556. *See also* NYC Bar comments.

[13] Pearlman testimony at 17.

[14] Pearlman testimony at 24.

[15] *See, e.g.,* Taylor testimony at 112; Battle testimony at 120. The Treasury Department did not object to the proposal. Pearlman testimony at 25. *See also* NYC Bar comments.

[16] *See e.g.,* Pearlman testimony at 25; Maletta testimony at 188-89. *See also* NYC Bar comments. The Treasury Department expressed reservations about elimination of the continuity of business enterprise test. Pearlman testimony at 25.

[17] Taylor testimony at 113. Mr. Roche opposed this proposal. Roche testimony at 281-83.

[18] Pearlman testimony at 27-28. It was also suggested that consideration should be given to using the present value, rather than the principal amount, of the security. Testimony of Price Waterhouse (hereinafter "PW testimony") at 216.

[19] PW testimony at 216. The Treasury Department expressed some concern about this rule. Pearlman testimony at 25-27.

[20] *See, e.g.,* Pearlman testimony at 13, 19; Andrews testimony at 70-73; Taylor testimony at 111-13; Alexander testimony at 130; Jacobs testimony at 141. *See also* NYC Bar comments.

[21] Pearlman testimony at 19.

[22] *See, e.g.,* Pearlman testimony at 19-20; Andrews testimony at 71-73.

[23] *See, e.g.,* Nolan testimony at 148, 150; Testimony of Edwin S. Cohen on behalf of Chamber of Commerce of United States (hereinafter "Cohen testimony") at 181; Maletta testimony at 191-92; PW testimony at 211; Roche testimony at 272; Testimony of Arthur Andersen & Co. (hereinafter "AA testimony") at 382; DHS testimony at 459-61; Testimony of J. Roger Mentz (hereinafter "Mentz testimony") at 561-62; Testimony of Alan Aronsohn on behalf of National Realty Committee (hereinafter "Aronsohn testimony") at 572-73; Testimony of Sherman & Howard (hereinafter "SH testimony") at 593-94

[24] *See, e.g.,* Nolan testimony at 148, 151, 153-57 (concern regarding taxation of largely inflationary gains of closely-held family businesses); Cohen testimony at 174-76 (impact on small closely-held corporations); Maletta testimony at 185; Roche testimony at 269-70; AA testimony at 383, 387; SH testimony at 593-95. Mr. Nolan indicated that the "impact [of a repeal of *General Utilities*] will be almost entirely on closely held famiy businesses." Nolan testimony at 148, 151.

verse effect on incorporated drugstores,[25] incorporated farms,[26] family businesses,[27] closely-held corporations,[28] and family holding companies.[29]

While certain of those who testified in opposition to the repeal of *General Utilities* agreed that the repeal might be appropriate in the case of non-liquidating distributions, or liquidating distributions of ordinary income assets, liquidating distributions of long-held assets were generally viewed by those individuals as entitled to special treatment.[30]

### *3. Relief from repeal of General Utilities doctrine*

Most people who testified indicated that some form of relief from the repeal of *General Utilities* was appropriate. A number of people recommended a shareholder credit proposal, similar to that contained in the American Law Institute study.[31] Others indicated a preference for a corporate-level exemption on long-term gains.[32] In certain cases, it was conceded that while there was no theoretical reason compelling *any* form of relief, the tax results of a repeal of *General Utilities,* without relief, seemed "wrong."[33] In almost all cases, it was indicated that any relief should appropriately be limited to long-held capital assets.[34]

In addition, a number of people testified in favor of deferring either the shareholder level and/or corporate level tax in an in-kind liquidation.[35] The reason for this proposal seemed to be the notion that, at least where an in-kind liquidation has little or no economic substance and the historic shareholders continue to operate the business after the distribution, the tax cost of an outright repeal of *General Utilities,* without relief, was too harsh.[36]

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[25] *See, e.g.,* Cohen testimony at 172.

[26] *See, e.g.,* Cohen testimony at 173.

[27] *See, e.g.,* Nolan testimony at 148, 151, 170.

[28] *See, e.g.,* Nolan testimony at 151; AA testimony at 383, 387.

[29] *See, e.g.,* Mentz testimony at 565.

[30] *See, e.g.,* Nolan testimony at 152 (no strong objection to repeal of *General Utilities* in the case of ordinary, nonliquidating distributions); Mentz testimony at 564 (there may be some justification for taxing liquidating distributions of inventory).

[31] *See, e.g.,* Pearlman testimony at 13, 21; Taylor testimony at 112-13 (favored either a shareholder credit or a reduction in the capital gains tax paid by the corporation); Battle testimony at 114, 118-19 (proposed, alternatively, a shareholder credit, a corporate level exemption on long-held assets, or retention of current law); Alexander testimony at 131; PW testimony at 211-12; Aronsohn testimony at 573-74. *See also* NYC Bar comments.

[32] *See, e.g.,* Testimony of Edward N. Delaney on behalf of the Tax Section of the American Bar Association (hereinafter, "Delaney testimony") at 90; Jacobs testimony at 142-43,170; Nolan testimony at 169 (the exemption approach "should be carefully considered if *General Utilities* is to be repealed"); Roche testimony at 276. The Treasury Department opposed the exemption approach. Pearlman testimony at 22.

[33] Jacobs testimony at 142-43.

[34] *See, e.g.,* Delaney testimony at 90; Taylor testimony at 112-13; Jacobs testimony at 142, 170; Roche testimony at 270, 276; Mentz testimony at 564-65.

[35] *See e. g.,* Pearlman testimony at 29-30 (recommended deferring corporate level tax with shareholders obtaining a carryover basis in the assets distributed. Relief, however, would be conditioned upon no death step-up under section 1014, and gain would, in any event, be taxed to the extent of undistributed earnings received); Delaney testimony at 90; Nolan testimony at 169 ("some form of carryover or substituted basis solution has merit and should be carefully explored"); PW testimony at 212; Berenson testimony at 232-33 (preferred substitute basis alternative); Roche testimony at 284 (preferred deferred corporate level tax and no shareholder level tax, except to the extent of cash received; shareholder treatment would be limited to those who held stock for specified period of time); Aronsohn testimony at 574. *See also* NYC Bar comments and August 16, 1983 letter to Senator Dole from Harold Handler on behalf of the Committee on Taxation, the Association of the Bar of the City of New York.

[36] *Cf., e.g.,* Pearlman testimony at 29-30; Cohen testimony at 175.

Other "relief" proposals that were suggested included expanding Subchapter S,[37] providing special relief for certain closely-held corporations,[38] and transitional relief.[39]

### *4. Proposals relating to net operating losses*

The vast majority of people who testified on the subject of net operating losses indicated support for the general approach proposed in the Staff Report to limit the use of net operating losses by an acquiring party after an acquisition to the use of such losses that would have been available to the target corporation, had no acquisition taken place.[40] However, most of the people who testified recommended a single rule applicable to all acquisitions rather than separate rules for "purchases" and "mergers" as originally proposed in the Staff Report.[41] In general, the preference for a single rule was based upon concern that the "merger" rule, as well as the interplay of the two rules, would be excessively complex.[42]

In connection with the net operating loss proposals, some individuals raised concerns as to whether an appropriate rate of return could be determined.[43] In addition, several people mentioned support for certain specific issues proposed in the Staff Report, including the treatment of investment assets[44] and the treatment of built-in losses.[45]

### *5. Proposals relating to publicly-traded limited partnerships*

Several people testified in favor of the proposal contained in the Staff Report to treat publicly-traded limited partnerships as corporations for tax purposes.[46] The majority of people who testified on

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[37] Cohen testimony at 173.

[38] Delaney testimony at 90.

[39] *See, e.g.*, Pearlman testimony at 23; Delaney testimony at 89-90.

[40] *See, e.g.*, Pearlman testimony at 14, 55; Delaney testimony at 95; Taylor testimony at 110; Jacobs testimony at 140; Testimony of Richard L. Bacon (hereinafter, "Bacon testimony") at 248.

[41] *See, e.g.*, Pearlman testimony at 14, 58; Delaney testimony at 96; Battle testimony at 121; Jacobs testimony at 146-47; Bacon testimony at 245, 247; AA testimony at 393-94; DHS testimony at 464. The New York State Bar Tax Section indicated support for the "purchase" and "merger" rules, but concluded that should there be only one rule, it preferred a single "purchase" rule to either the 1954 or 1976 versions of section 382. Taylor testimony at 99, 110-11.

[42] *See, e.g.*, Pearlman testimony at 58; Delaney testimony at 96; Battle testimony at 121; Jacobs testimony at 146-47; Bacon testimony at 249-51.

[43] *See, e.g.*, Pearlman testimony at 55-56; Bacon testimony at 250; Berenson testimony at 239-41; AA testimony at 394.

[44] Pearlman testimony at 60; Bacon testimony at 245 (would subtract cash and passive investments from value of loss company).

[45] Pearlman testimony at 62; Delaney testimony at 97 (recommended express statutory provisions to address built-in loss problem). The Treasury Department expressed some concerns about the proposed treatment of built-in gains. Pearlman testimony at 61-62.

[46] *See, e.g.*, Taylor testimony at 108; Alexander testimony at 128, 135.

[47] *See, e.g.*, Pearlman testimony at 14,63; Testimony of Raymond Plank on behalf of Apache Corp. at 324; Testimony of George S. Slocum on behalf of Transco Energy Company at 344; Testimony of Louis H. Sandler on behalf of Southwest Realty, Ltd. at 362; Testimony of Robert McDermott on behalf of Timber Realization Co. (hereinafter, "McDermott testimony") at 375; AA testimony at 395-402; Testimony of Michael L. Schler on behalf of Blyth Eastman Paine Webber Incorporated at 413-17; Testimony of Martin C. Schwartzberg on behalf of the Coalition for Low and Moderate Income Housing at 428-31; Testimony of Howard C. Wadsworth on behalf of Dorchester Hugoton, Ltd. at 466-68; Testimony of David G. Glickman on behalf of May Energy Partners, Ltd. and Snyder Oil Partners at 503-05, Testimony of Sanford E. McCormick on behalf of McCormick Oil and Gas Company at 545-46; Testimony of Hart H. Spiegel on behalf of Newhall Investment Properties and Newhall Resources (hereinafter, "Spiegel testimony") at 585; Testimony of Brian F. Egolf on behalf of Petroleum Investments, Ltd. at 587-88. The Treasury Department's principal objection to the proposal was that it involved tax policy considerations beyond the scope of the project. Pearlman testimony at 63.

[48] *See* questioning of Senator Danforth at 376-79.

Continued

the subject, however, opposed the proposal,[47] although no clear explanation was provided as to the non-tax business distinctions between a shareholder of a corporation and a limited partner in a publicly-traded limited partnership.[48] Several people indicated that publicly-traded limited partnerships should be treated no differently than large limited partnerships, generally.[49] Several others indicated that more time should be given to consider the proposal.[50]

### *6. General procedure for proceeding*

Several people indicated a need to proceed in a fairly deliberate fashion, with ample time to consider the significance of the proposals.[51] For example, the Treasury Department stated that "we strongly believe that adoption of these proposals should come only after they have been translated into specific statutory provisions and subjected to deliberate and detailed technical and policy analyses by all interested parties." [52] Certain individuals testified that the acquisitions proposals and the proposals relating to net operating losses should only be enacted as a complete package.[53]

## II. Description of Current Law

### *A. Incorporations and other transfers to controlled corporations*

#### *1. General rules*

Generally, except as expressly provided to the contrary, gain or loss is recognized for Federal income tax purposes on the exchange of property. An exception to this principle is provided for certain transfers to controlled corporations. Under this rule, no gain or loss is recognized by a person [54] on the transfer of property to a controlled corporation solely in exchange for stock or securities in such corporation (section 351(a)). Further, no gain or loss is recognized to the transferee corporation on the issuance of its stock or securities in exchange for the property (section 1032). Gain, but not loss, is recognized to the transferor to the extent that the consideration for the transfer consists of money or property other than stock or securities of the transferee. The transferee's basis in the property received is the same as the basis of the transferor in the property, increased by the gain, if any, recognized by the transferor in the transaction (section 362). The transferor's basis in the stock or securities received in exchange for the property is equal to its basis in the property transferred, subject to certain adjustments (section 358).

#### *2. Control requirement*

A transaction qualifies for nonrecognition treatment under section 351 only if, immediately after the exchange, the transferor or transferors are in control of the transferee corporation. If, after the exchange, a transferor sells or exchanges stock of the transferee received in the exchange, and the sale or exchange is pursuant to a plan established prior to the transfer to the controlled corporation, the control requirement may not be satisfied.[55] "Control" for this purpose is defined in section 368(c) to mean stock possessing at least 80 percent of the voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock.

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[49] *See, e.g.*, McDermott testimony at 375; Spiegel testimony at 578–80.

[50] *See, e.g.*, Pearlman testimony at 63; Battle testimony at 123–24; Jacobs testimony at 147.

[51] *See. e.g.*, Pearlman testimony at 14; Taylor testimony at 100; Battle testimony at 117; Maletta testimony at 189–90; Roche testimony at 265–67.

[52] Pearlman testimony at 14.

[53] *See, e.g.*, Berenson testimony at 239.

[54] The term "person" is defined to include an individual, a trust, estate, partnership, association, company or corporation (section 7701(a)(1)).

### *3. Business purpose requirement*

The Internal Revenue Service takes the position that an exchange qualifying for nonrecognition treatment under section 351 must have a bona fide non-tax business purpose.[56]

### *4. Overlap between transfers to controlled corporations and acquisitive transactions*

An acquisitive transaction may be structured as a transfer to a controlled corporation. For example, assume that (1) an acquiring corporation desires to acquire a target corporation, (2) a majority of the target shareholders wish to receive cash in the transaction, and (3) a minority target shareholder wishes to receive stock. Assume that the transaction cannot be structured as a tax-free "reorganization" (described below).

The transaction could be accomplished as follows. First, the minority shareholder joins with the acquiring corporation in the formation of a holding company. The minority shareholder transfers his stock in the target corporation for preferred stock in the holding company and the acquiring corporation transfers cash for all of the holding company's common stock. The exchanges by the minority shareholder and the acquiring corporation are not taxable because the transactions involved in the formation of the holding company constitute tax-free transfers to a controlled corporation.

Second, the holding company uses the cash contributed by the acquiring corporation to purchase the remaining target corporation shares. The remaining target corporation shareholders are taxable on the sale of their shares. Further, as explained more fully below, the transaction may be treated (at the election of the acquiring corporation) as a purchase of the assets of the target corporation, resulting in a stepped-up basis for those assets.

The Internal Revenue Service, reversing a prior ruling, has held that the minority shareholder in this transaction is entitled to tax-free treatment because the provisions conferring tax-free status on transfers to controlled corporations apply to the formation of the holding company.[57] The rulings that held to the contrary viewed the transaction as merely a step in a taxable acquisition of the target corporation that should not be given independent significance.

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[55] *See* Rev. Rul. 54-96, 1954-1 C.B. 111.

[56] Rev. Rul. 60-331, 1960-2 C.B. 189.

[57] Rev. Rul. 84-71, 1984-1 C.B. 106, reversing Rev. Rul. 80-284, 1980-2 C.B. 117 and Rev. Rul. 80-285, 1980-2 C.B. 119.

### *5. Assumption of liabilities*

The assumption of liabilities by the transferee (or the receipt of property by the transferee subject to liabilities) in connection with a tax-free transfer to a controlled corporation is not treated as "other property" (*i.e.,* boot) requiring the transferor to recognize gain in the transaction unless the principal purpose of the assumption or acquisition is tax avoidance, or is not a bona fide business purpose. This treatment applies as well to a corporation whose assets are acquired in a reorganization. In either case, the liabilities are treated as money received by the transferor solely for purposes of determining the transferor's basis in the stock and securities received without recognition of gain.

Further, gain is recognized on transfers to controlled corporations and D reorganizations (described below) to the extent that the liabilities assumed or acquired exceed the basis of the transferred properties. Certain liabilities which would give rise to a deduction to the transferor, such as accounts payable, are not taken into account for purposes of this rule or for purposes of determining the transferor's basis in stock or securities received without recognition of gain.

### *6. Treatment of securities and installment sales*

Section 351 applies to the receipt of a debt instrument by the transferor only if the instrument constitutes a "security." If the debt instrument is not a security, the transferor will recognize gain, which may be reported on the installment sale method. The transferee's basis in the transferred property is increased by the amount of gain recognized to the transferor on the exchange (section 362(a)).[58]

A transfer of property by a controlling shareholder in exchange for an installment obligation of a controlled corporation may take place in the form of a sale of the property to the corporation. If the form of the transaction controls the tax consequences, the proported installment sale results in a deferral of gain to the shareholder under the installment method and a cost basis to the corporation for the transferred property.[59]

## *B. Tax-free reorganizations*

### *1. Introduction*

Another exception to the general principle providing that gain or loss is recognized for Federal income tax purposes on the exchange of property is found in the reorganization provisions of the Code, and applies to certain exchanges of stock for stock of another corporation or exchanges of corporate assets for stock or securities of another corporation. The purpose of these provisions is to allow the deferral of gain realized on the exchange if, in general, the exchange (1) is incident to a restructuring of a corporation that is a party to the reorganization, (2) has a valid business reason, and (3) effects only a readjustment of continuing interests in the corporate property under modified corporate form (Treas. Reg. section 1.368-1(b)).

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[58] Proposed regulation section 1.453-1(f)(3)(ii) (May 3, 1984) would require the basis increase to be deferred until the transferor recognizes gain under the installment method.

[59] *See Warren H. Brown,* 27 T.C. 27 (1956).

In general, for a transaction to qualify as a "reorganization", it must be described in section 368(a). In addition, there are several nonstatutory requirements that generally apply for purposes of determining whether a transaction qualifies for reorganization treatment.

### *2. Acquisitive transactions described in section 368(a)*

Six different types of acquisitive transactions are described in section 368(a). For the most part, these are distinguished by the corporate formalities of the transaction, the consideration that is required to be paid, and the property that must be transferred.

*a. "A" reorganizations.*—A type A reorganization is a statutory merger or consolidation under State law (section 368(a)(1)(A)). No express limitations are imposed on the type of consideration that can be used in the transaction or on the disposition of assets prior to the merger.

*b. "B" reorganizations.*—A type B reorganization is an acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not the acquiring corporation had control immediately before the acquisition) (section 368(a)(1)(B)).

*c. "C" reorganizations.*—A type C reorganization is an acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of "substantially all" of the properties of another corporation (section 368(a)(1)(C)). In addition, as a result of a requirement adopted in the Tax Reform Act of 1984, the transferor corporation in a C reorganization must distribute the stock, securities, and other properties it receives from the acquiring corporation, as well as any retained assets, as part of the plan of reorganization.[60]

The percentage of the total assets of the transferor corporation that must be transferred to satisfy the "substantially all" requirement is uncertain. The Internal Revenue Service has ruled that no particular percentage is controlling. The nature of assets retained by the transferor, the purpose of retention, and the amount retained are all to be considered.[61] For ruling purposes, the transfer of 90 percent of net assets and 70 percent of gross assets, taking into account distributions and redemptions that are pursuant to the plan of acquisition, is deemed to be "substantially all".[62]

In determining whether the exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the transferor corporation, or the fact that the property acquired is subject to a liability, is disregarded. The liability is, however, treated as consideration other than voting stock. Such consideration may be used, but only up to 20 percent of the fair market value of the transferred assets.

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[60] P.L. 98-369, section 63, which enacted new section 368(a)(2)(G).

[61] Rev. Rul. 57-518, 1957-2 C.B. 253.

[62] Rev. Proc. 77-37, 1977-2 C.B. 568.

Thus, for example, if the liabilities of the transferor assumed by the acquiring corporation constitute 30 percent of the total consideration, but the only other consideration is voting stock of the acquiring corporation, the transaction may still qualify as a C reorganization. If, in the same transaction, the consideration also includes $1 in cash, the reorganization status may be lost.

It has been held that a predisposition of assets by a target corporation prior to the acquisition of the remaining assets by an acquiring corporation causes the acquisition to fail as a C reorganization because the acquisition is less than substantially all of the target corporation's properties.[63] This may be contrasted with an A or B reorganization where a predisposition of some of the target's assets prior to the merger or stock acquisition will generally not cause the transaction to fail to qualify as a reorganization.[64]

*d. Forward triangular merger.*—A forward triangular merger is the acquisition by one corporation of substantially all of the assets of another corporation in exchange for stock or securities of a corporation that is in control of the acquiring corporation, and that is generally accomplished through a merger of the acquired corporation into the acquiring corporation (section 368(a)(2)(D)). No stock of the acquiring corporation can be used in the transaction, although securities of the acquiring or controlling corporation may be used (Treas. Reg. section 1.368-2(b)(2)). The substantially all requirement may cause failure of a transfer to qualify as a forward triangular merger because of a preliminary disposition of assets by the acquired corporation under the *Elkhorn Coal* rationale.

*e. Reverse triangular merger.*—A reverse triangular merger is similar to a forward triangular merger, except that the subsidiary of the corporation whose stock is used in the transaction merges into the acquired corporation (section 368(a)(2)(E)). After the transaction, the corporation surviving the merger must hold substantially all of (1) its properties and (2) the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). In addition, shareholders of the surviving corporation must surrender an amount of stock constituting control of such corporation solely for voting stock of the corporation acquiring control.

*f. "G" reorganizations.*—Certain acquisitions of corporations in a title 11 or similar case (bankruptcy, receivership, foreclosure, etc.) can qualify as type G reorganizations (section 368(a)(1)(G)).

### *3. Other transactions described in section 368(a)*

Three other principal types of reorganizations are described in section 368(a).[65]

*a. "D" reorganizations.*—A type D reorganization is a transfer by a corporation of all or a part of its assets to a corporation controlled immediately after the transfer by the transferor or its shareholders.[66] A transaction qualifies as a D reorganization, however, only if, in pursuance of the plan of reorganization, stock or securities of the controlled corporation are distributed in a transaction which qualifies under sections 354, 355 or 356 (section 368(a)(1)(D)). As explained more fully below, D reorganization status may result in dividend treatment to shareholders where the transaction is in form a liquidation, but the business assets remain in corporate solution and control of the business is retained by the same shareholders. The "substantially all" requirement, as applied to D reorganizations, has been construed liberally to achieve this result so that, for example, in a case where the operating assets transferred constituted only 15 percent of the transferor's total assets, the "substantially all" requirement was held to be satisfied.[67]

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[63] *Helvering* v. *Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir., 1938), *cert. denied*, 305 U.S. 605 (1938).

[64] *See, e.g., Commissioner* v. *Morris Trust*, 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 68-603, 1968-2 C.B. 148.

[65] As described more fully below, section 368(a) also contains rules relating to reorganizations of investment companies.

*b. "E" reorganizations.*—A type E reorganization is a recapitalization (section 368(a)(1)(E)). Generally, the term recapitalization refers to a "reshuffling of a capital structure within the framework of an existing corporation." [68]

*c. "F" reorganizations.*—A type F reorganization is a mere change in identity, form, or place of organization of one corporation (section 368(a)(1)(F)).

### *4. Ordering rules*

A transaction may appear to constitute more than one type of reorganization. Further, the consequences of the different types of reoganizations may vary. Thus, "ordering rules" are provided for resolving certain overlap questions. For example, if a transaction is described as both a C and D reorganization, it is treated solely as a D reorganization (section 368(a)(2)(A)).

Other ordering rules have been provided by the Internal Revenue Service and the courts. In transactions which may qualify as both an A reorganization and as either a C or D reorganization, no express rule is provided. Some commentators have argued that the historical priority of nonrecognition treatment of mergers should control, permitting A reorganization status even if the transaction could qualify under another provision.[69] In the case of at least one transaction which could have qualified as either a triangular A reorganization or a B reorganization, the Internal Revenue Service ruled that the transaction was a B reorganization.[70] Overlap questions also arise between A and F reorganizations,[71] and between B and C reorganizations.[72]

As described earlier, overlap questions may also arise between section 351 transactions and the reorganization provisions.

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[66] The control requirement applicable generally to reorganizations means the ownership of 80 percent of the voting power and 80 percent of each class of nonvoting stock, except that for D reorganizations, control is defined in section 304(c) to mean 50 percent of voting power or value, determined by applying constructive ownership rules.

[67] *Smothers Company* v. *United States*, 642 F.2d 894 (5th Cir. 1981).

[68] *See* S.M. 3710, IV-1 C.B. 4 (1925).

[69] *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Par. 14.12 (4th Ed., 1979).

[70] *See* Rev. Rul. 67-448, 1967-2 C.B. 144.

[71] Rev. Rul. 57-276, 1957-1 C.B. 126 (F reorganization status controls).

[72] *See, e.g., Commissioner* v. *Dana*, 103 F.2d 359 (3d Cir. 1939).

Finally, when a holding company exchanges the stock in its subsidiary corporation for voting stock of an acquiring corporation, the transaction may satisfy the definitional requirements of either a B or C reorganization [73] and, in addition, may satisfy the rules providing tax-free treatment for transfers to controlled corporations.[74]

### *5. Use of stock of corporation in control of the acquiring corporation*

Present law generally permits stock of a corporation in control of the acquiring corporation to be used in B or C reorganizations. As indicated above, subject to certain other conditions, stock of the corporation controlling the acquiring or acquired corporation may be used in forward or reverse triangular mergers. In addition, in A, B, and C reorganizations, some or all of the assets or stock acquired may be dropped down to a corporation controlled by the acquiring corporation (section 368(a)(2)(C)). These provisions embody a statutory reversal of decisions under prior law that treated a controlling corporation as not being a party to a reorganization where the acquired properties were transferred directly or indirectly via the controlling corporation to its subsidiary.[75]

The Internal Revenue Service has ruled that an acquisition of substantially all of a target corporation's assets by a corporation in exchange for "grandparent" stock (*i.e.,* stock of a corporation in control of the parent of the acquiring corporation) qualified as a reorganization.[76] The transaction is equivalent to a direct acquisition by the parent corporation followed by a dropdown.[77] However, it is not clear that such a result would be sanctioned in a triangular B reorganization context, where the result would be four corporate tiers. The principle of the *Groman* and *Bashford* decisions continues to be relevant to the extent that statutory modifications have not negated their application.

### *6. Nonstatutory requirements*

In general, transactions of the kind described above qualify as tax-free reorganizations only if certain nonstatutory requirements are also satisfied.

*a. Continuity of interest.*—A transaction satisfies the continuity of interest requirement only if the shareholders of the acquired corporation receive an equity interest in the acquiring corporation or, subject to the limitations indicated above, stock of the corporation controlling the acquiring corporation.

There is some controversy regarding how significant the equity interest must be in order to satisfy this requirement. In addition, it is not clear whether the acquired corporation's shareholders must retain their equity interest in the acquiring corporation for any specified period of time. In *McDonald's Restaurants of Illinois, Inc.*

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[73] If the subsidiary's stock was all or substantially all of the holding company's property, the regulations suggest that B reorganization status does not apply. Treas. Reg. section 1.368-2(f), last sentence.

[74] Rev. Rul. 70-433, 1970-2 C.B. 82.

[75] *Groman* v. *Commissioner,* 302 U.S. 82 (1937); *Helvering* v. *Bashford,* 302 U.S. 454 (1938).

[76] Rev. Rul. 64, 73 1964-1 C.B. 143.

[77] A combination of a direct subsidiary merger for controlling corporation stock followed by a dropdown to a second tier subsidiary has been ruled to constitute a valid A reorganization. Rev. Rul. 72-576, 1972-2 C.B. 217.

v. *Commissioner,*[78] for example, the Tax Court took the position that, because a subsequent sale of the stock of the acquiring corporation that was received in the transaction was not accomplished pursuant to a binding commitment entered into prior to the transaction, the continuity of interest requirement was satisfied. The Seventh Circuit reversed, holding that continuity of interest was not present. The court appeared to rely on the fact that prior to the acquisition, the shareholders of the target corporations intended to sell the shares they received in the acquisition.

*b. Continuity of business enterprise.*—Under regulations, for a transaction to qualify as a tax-free reorganization, there generally must be a "continuity of the business enterprise under modified corporate form" (Treas. Reg. section 1.368-1(b)). To satisfy this requirement, the acquiring corporation must either continue the acquired corporation's historic business or use a significant portion of such corporation's business assets in a business (Treas. Reg. section 1.368-1(d)(2)).

*c. Business purpose.*—Generally, a transaction can qualify as a tax-free reorganization only if engaged in for valid non-tax business reasons. There is some controversy regarding whether a shareholder business purpose (as opposed to a corporate business purpose) is sufficient.

#### *7. Step transaction doctrine*

Under the step transaction doctrine, formally distinct transactions may be integrated to determine the tax treatment of the entire series.

There is some controversy regarding the appropriate standard that is to be employed in applying the step transaction doctrine. The doctrine has been variously expressed as requiring a binding commitment, a mutual interdependence of steps, or merely a particular end result.

Under the binding commitment approach, formally distinct transactions are integrated only if the affected taxpayers are contractually bound to take subsequent steps after they take the initial step. Under the mutual interdependence approach, transactions are integrated if they would have been fruitless without completion of the series. Finally, under the end result approach, if a series of otherwise independent transactions, on the one hand, and a single transaction, on the other hand, would have produced the same end result, the series of independent transactions may be integrated.

### *C. Consequence of tax-free reorganization to corporations and shareholders*

#### *1. Introduction*

The treatment of a corporation that is a party to a reorganization, or of a shareholder exchanging stock in a reorganization, depends on the type of the reorganization, and the consideration received.

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[78] *McDonald's Restaurants of Illinois, Inc.* v. *Commissioner,* 688 F.2d 520 (9th Cir. 1982), *rev'g.* 76 T.C. 972 (1981).

### *2. Treatment of acquired and transferor corporations*

*a. Stock acquisitions.*—Generally, no gain or loss is recognized by an acquired corporation on a tax-free acquisition (from its stockholders) of its stock. Further, a tax-free acquisition of a corporation's stock does not affect such corporation's basis in its assets.

*b. Asset acquisitions.*—No gain or loss is recognized to a transferor corporation on the transfer of its assets solely in exchange for stock or securities of another corporation that is a party to the reorganization (section 361(a)). Further, in the case of a C reorganization, no gain or loss is recognized on the receipt of a limited amount of cash or other property, so long as such cash or property is distributed to the transferor corporation's shareholders pursuant to the plan of reorganization (section 361(b)). As noted above, such a distribution is generally required for the transaction to qualify as a C reorganization (section 368(a)(2)(G)). However, it has been held that the transferor recognizes gain when the property is distributed to shareholders who undertake to pay the corporation's creditors since the shareholders serve merely as a conduit in a disposition that does not insulate the corporation from gain recognition.[79]

*c. Basis in property received.*—The basis to a transferor corporation in stock or securities received by such corporation in exchange for property is its basis in the transferred property, increased by the amount of the gain, if any, recognized to the transferor corporation on the exchange, and decreased by the amount of any "boot" that is received. In addition, the transferor's basis is reduced by the amount of any liabilities assumed (or taken subject to) by the transferee on the exchange (section 358). The basis to a transferor corporation of any other property received (except money) is fair market value.

*d. Link to consideration paid to shareholders.*—The tax consequences to the acquired and transferor corporations depend, in part, upon the consideration paid to the shareholders in the transaction. As described above, the doctrine of continuity of shareholder interest is a necessary prerequisite to reorganization treatment. Thus, for example, the Supreme Court recently held that a statutory merger of a stock savings and loan association into a mutual savings and loan association was not a reorganization because the shareholders of the transferor, who received savings accounts and certificates of deposit in the merger, did not have sufficient continuity of interest in the surviving entity.[80] As a result, the merger was also a taxable one to the corporate entities, and the transaction was a taxable disposition of assets.

In the case of a stock acquisition, the acquired corporation is generally unaffected, whether the acquisition is taxable or tax-free to the shareholders of the acquired corporation. Thus, for example, if consideration other than voting stock of the acquiring corporation is used, the transaction will not qualify as a B reorganization and will be taxable to all shareholders of the acquired corporation, but failure to qualify as a B reorganization will not affect the acquired corporation itself. However, the taxable status of the stock acquisition may, as described below, permit the acquiring corporation to elect to treat the acquired corporation as if it sold its assets in a liquidating sale. The election is not available if the stock acquisition constitutes a B reorganization.

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[79] *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609 (1938).

[80] *Harold T. Paulsen* v. *Commissioner,* 53 U.S.L.W. 4029 (January 8, 1985).

### *3. Treatment of acquiring corporation*

Generally, a corporation does not recognize any gain or loss if it acquires property (including stock or assets of an acquired corporation) in exchange for its stock (section 1032). An acquiring corporation will recognize gain, however, to the extent that the consideration used consists not solely of its stock but also of appreciated property (including stock or securities of a related or controlled corporation that is not a party to the reorganization) (section 1001).

The basis to an acquiring corporation of property received in a tax-free reorganization is the basis of the property in the hands of the transferor, increased by the amount of gain, if any, recognized to the transferor on the transfer (section 362). In the case of a B reorganization, this rule requires a determination of the basis in the stock of the acquired corporation previously held by all of the shareholders who surrendered stock in the transaction.

### *4. Treatment of shareholders*

*a. Receipt of stock or securities of a party to the reorganization.*—In general, shareholders of a corporation that is a party to a reorganization are entitled to exchange their stock for stock of another corporation that is a party to the reorganization, pursuant to the plan of reorganization, without recognition of gain or loss (section 354(a)(1)). In addition, debt securities held by such shareholders may be exchanged tax-free for debt securities of the other corporation having an equal or lesser principal amount (section 354(a)(2)).

*b. Receipt of boot.*—Gain (but not loss) is recognized, however, on the receipt of boot to the extent of the lesser of the amount of the boot received or the gain realized (section 356). The fair market value of the excess principal amount of securities received over securities surrendered constitutes boot. Boot is taxed as gain from the sale or exchange of stock unless it has the effect of a dividend. In the latter case, boot to the extent of gain is taxed as a dividend. Consideration (other than stock) received in exchange for section 306 stock is taxed as a dividend to the extent of earnings and profits.

Present law provides no explicit guidelines for determining whether the receipt of boot has the effect of the distribution of a dividend. Where, outside the reorganization context, stock of a shareholder is redeemed for corporate property, present law provides rules to determine whether the shareholder should receive capital gains treatment or whether the redemption distribution should be treated as a dividend. While these rules are considered applicable to the characterization of receipt of boot in a reorganization, the cases are inconsistent in determining the manner in which the test is to be employed.

In one case, it was held that the shareholder should be viewed as if only stock in the acquiring corporation was initially received in the transaction and a portion of that stock was then redeemed by the acquiring corporation (in an amount equal to the boot received).[81] In another case, it was held that the test requires the shareholder to be treated as if a portion of its stock in the transferor was redeemed in exchange for the boot immediately prior to the reorganization exchange.[82]

In addition, where a distribution has the effect of a dividend, it is not entirely clear whether the earnings and profits to be used in determining the extent of the dividend are those of the transferor corporation, the acquiring corporation, or both. In general, the earnings and profits of the transferor are used. However, where there is common control of the transferor and the acquiring corporation, the earnings and profits of both may be counted.[83]

*c. Basis in property received.*—The basis to a shareholder in stock or securities received in a reorganization is the shareholder's basis in the stock or securities surrendered, increased by the amount of gain, if any, recognized on the exchange, and decreased by the amount of any boot that is received (section 358). The basis in any other property (except money) received is fair market value.

*d. Link to consideration received by other shareholders.*—The tax consequences to a particular shareholder depend, in part, upon the consideration received by other shareholders in the transaction. For example, as noted above, a B reorganization requires that only voting stock in the acquiring corporation be used as consideration in the transaction. Thus, any shareholder receiving cash in a purported B reorganization will cause the receipt of voting stock by all of the other shareholders to be fully taxable to them.

### *5. Carryover of attributes*

In general, tax attributes of an acquired corporation in a reorganization carry over to an acquiring corporation as of the close of the day of the reorganization (section 381(a)). The taxable year of the acquired corporation in an acquisition other than an F reorganization terminates on the date of the acquisition (section 381(b)).

### *6. Whipsaw*

A determination of whether a transaction constitutes a reorganization or a taxable exchange often requires analysis and characterization of sophisticated fact patterns. It is not uncommon for different parties to a transaction to take inconsistent positions regarding the proper characterization of the transaction.

In at least one case, the Internal Revenue Service has been placed in the untenable position of ruling with respect to a particular taxpayer that a transaction was to be taxed in a particular way only to have another taxpayer, whose interest differed from that of the taxpayer who obtained the ruling, secure a contrary characterization in court. In *King Enterprises, Inc.* v. *United States,*[84] the Internal Revenue Service ruled that an exchange of all the stock of the acquired corporation for stock, notes, and cash of the acquiring corporation, followed by a merger of the acquired corporation into the acquiring corporation, was a taxable transaction and resulted in a fair market value basis in the assets transferred. The transaction failed to qualify as a B reorganization because the consideration consisted of notes and cash as well as stock. Further, because the subsequent merger was not part of the acquisition, the transaction was not an A reorganization. In a case brought by a corporate shareholder, however, the Court of Claims held that the transaction constituted an A reorganization on the grounds that all the steps were part of an integrated transaction and there was sufficient continuity of interest. The result was that the corporate shareholder obtained a dividends-received deduction with respect to the substantial pro rata boot received.

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[81] *Wright* v. *United States,* 482 F.2d 283 (8th Cir. 1973).

[82] *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978).

[83] Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant* v. *Commissioner,* 366 F.2d 874 (5th Cir. 1966), *cert denied* 386 U.S. 1022 (1967).

[84] *King Enterprises, Inc.* v. *United States,* 418 F.2d 311 (Ct. Cl. 1969).

Taxpayers also may be subject to effective whipsaw by the Government. For example, the Government may allege the existence of continuity of interest to one taxpayer in a case in which treating boot as a dividend will maximize taxes, while denying the existence of continuity of interest to another taxpayer where the denial of reorganization status will maximize the tax owed.

### *D. Investment companies*

#### *1. Transfers to investment companies under section 351*

The general rule contained in section 351(a), under which gain or loss generally is not recognized if property is transferred to a controlled corporation, does not apply to a transfer to an investment company (section 351(c)). Treasury regulations provide that the transactions which are prohibited by this rule are those that (a) result, directly or indirectly, in the diversification of the transferor's interests, and (b) are between a transferor and a regulated investment company (RIC), a real estate investment trust (REIT), or a corporation more than 80 percent of the assets of which (excluding cash and nonconvertible debt securities) are held for investment and are readily marketable stock or securities, including interests in RICs or REITs.

#### *2. Investment company reorganizations*

A reorganization involving two or more investment companies may not be treated as tax-free with respect to one or more of the corporate parties to the transaction as well as to its shareholders and security holders (section 368(a)(2)(F)). An exception applies in the case of investment companies that, before the transaction, are RICs, REITs, or are otherwise diversified. Generally, under these rules, a diversified investment company is an investment company not more than 25 percent of the noncash assets of which are invested in stock and securities of one issuer, and not more than 50 percent of the noncash assets of which are invested in stock or securities of five or fewer issuers. For purposes of this rule, all members of a controlled group are treated as a single issuer.

For these purposes, an "investment company" is defined as a RIC, a REIT, or a corporation 50 percent or more of whose noncash assets are stock and securities and 80 percent or more of whose noncash assets are held for investment. In making the 50-percent and 80-percent determinations, stock and securities in any subsidiary corporation is disregarded, and the parent corporation is deemed to own its ratable share of the subsidiary's assets. For this purpose, a corporation is treated as a subsidiary if the parent owns 50 percent or more of the voting power or value of that corporation.

The provision generally prevents shareholders in an undiversified investment company from achieving any tax-free diversification of their investment positions through the reorganization rules. However, the provision is generally inapplicable to a transaction in which a corporation that is not an investment company acquires (or is acquired by) an investment company, whether or not diversified.

### *E. Taxable acquisitions*

An acquisition by a corporation of the stock or assets of another corporation in exchange for cash, notes, stock of the acquiring corporation, or other property, or any combination of the foregoing, may be effected in a transaction that is taxable to the transferor or its shareholders.

#### *1. Taxable asset acquisitions*

*a. Acquisitions from nonliquidating corporations.*—If assets are acquired from a corporation that does not liquidate as part of the transaction, the transferor corporation recognizes gain (with respect to each asset sold) in an amount equal to the excess of the amount realized (*i.e.*, the amount of money plus the fair market value of other property received) over the corporation's adjusted basis in the asset (section 1001). Loss is generally recognized where the basis of property disposed of exceeds the amount realized. In general, gain or loss derived from property other than inventory and other ordinary income assets is treated as capital gain or loss.

Gain that would otherwise be treated as capital gain may be taxed as ordinary income under certain recapture rules such as section 1245 (gain from disposition of certain depreciable personal property), section 1250 (gain from disposition of certain depreciable real property), and section 1254 (gain from disposition of certain oil, gas or geothermal property). In addition, if property that qualified for the investment tax credit when originally acquired by the transferor corporation is disposed of prior to the close of the useful life (or recovery period) taken into account in computing the amount of the credit, a portion of the credit is recaptured and included, dollar for dollar, in the transferor's tax liability.

The acquiring corporation takes a cost basis in the acquired assets (section 1012). The acquiring corporation does not succeed to the tax attributes of the transferor, which remain with that corporation. The transferor corporation can use its net operating losses to offset gain, if any, from the sale of its assets.

*b. Acquisitions from liquidating corporations.*—Generally, if a corporation adopts a plan of complete liquidation and, within 12 months, all of the assets of the corporation are distributed in complete liquidation, no gain or loss is recognized by the corporation on the sale or exchange by it of property within such 12-month period (section 337). Thus, gain or loss is generally not recognized to a transferor corporation on a liquidating sale of its assets. Furthermore, as a general rule, no gain or loss is recognized to the transferor corporation on its liquidating distributions. However, gain or loss is recognized by the shareholders of the liquidating corporation on the exchange of their stock for the proceeds of the liquidation. Usually, such gain or loss is capital gain or loss. Shareholders may defer gain under the installment sale provisions to the extent the liquidating distribution consists of installment obligations of the acquiring corporation. In such case, payments in satisfaction of the obligations, rather than the obligations, are treated as received in exchange for the shareholder's stock (section 453(h)).

Gain is recognized to a transferor corporation on a liquidating sale of its assets (or the distribution to its shareholders of any retained assets), however, to the extent that there is recapture income. In general, amounts recaptured on the sale or liquidation are taxed to the transferor as ordinary income. In addition, certain nonstatutory doctrines, such as the tax benefit rule, may override the nonrecognition rule.[85]

As in the case of an acquisition from a nonliquidating corporation, the acquiring corporation takes a cost basis in the acquired assets (section 1012). Further, the acquiring corporation does not succeed to the tax attributes of the transferor corporation, even though the transferor is liquidated as part of the transaction.

*c. Liquidating sales v. nonliquidating sales.*—The rules applicable to liquidating sales of assets are much more generous than those applicable to nonliquidating sales. In either case, the acquiring corporation takes a cost, or fair market value, basis in the acquired assets. In the case of a liquidating sale, only recapture items are recognized as income at the corporate level. In contrast, in the case of a nonliquidating sale, gain generally is recognized at the corporate level.

### *2. Taxable stock acquisitions*

A taxable stock acquisition generally is characterized for Federal income tax purposes in accordance with its form. However, under certain circumstances, an acquiring corporation can elect to treat a stock acquisition as an acquisition of the assets of the acquired corporation.

An acquiring corporation can acquire the stock of another corporation in exchange for cash, notes, stock of the acquiring corporation, or other property, or any combination of the foregoing, in a transaction that is taxable, generally at capital gains rates, to the acquired corporation's shareholders. In such event, absent an election to treat the stock acquisition as an asset acquisition (described below), no gain or loss is recognized to, and no amount is recaptured by, the acquired corporation.

The acquiring corporation takes a cost basis in the stock of the acquired corporation (section 1012). However, absent the election described below, the acquired corporation's basis in its assets is not affected by the transaction. Further, the acquiring corporation does not directly succeed to any of the tax attributes of the acquired corporation, although the corporations in certain cases may join in the filing of a consolidated return for Federal income tax purposes, in which case the acquiring corporation may indirectly benefit from those tax attributes.

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[85] *See, e.g., Anders* v. *Commissioner,* 414 F.2d 1283 (10th Cir. 1969), *cert. denied,* 396 U.S. 958 (1969).

*a. Stock acquisitions treated as asset acquisitions.*—In a taxable stock acquisition, the acquiring corporation may elect to treat the transaction for tax purposes as if the assets of the acquired corporation were purchased as part of a larger transaction in which the acquired corporation is being liquidated (section 338).[86] In such an event, except to the extent minority owned shares remain outstanding, gain or loss is generally not recognized to the acquired corporation to the same extent that gain or loss would not have been recognized if there had been an actual liquidating sale of all of its assets. As in the case of a liquidating sale, the recapture rules are fully applicable.

In such a transaction, the acquired corporation is treated (1) as if it sold all of its assets for fair market value as of the close of the acquisition date and (2) as a new corporation which purchased such assets as of the beginning of the following day for an amount determined by reference to the basis, as adjusted, of the acquired stock. Thus, the acquired corporation's basis in all its assets is generally stepped up to reflect the price paid for its stock.[87] The tax attributes of the acquired corporation are terminated as a result of the election. The corporations may join in the filing of a consolidated return for Federal income tax purposes, except that recapture and other income of the acquired corporation resulting from the deemed sale of its assets must be accounted for on a separate return.

If two or more corporations are acquired from the same affiliated group, the rules require consistency of treatment so that asset acquisition treatment applies to all or to none of the acquired corporations. In addition, if assets are purchased either from the acquired corporation or an affiliate of the acquired corporation, the purchasing corporation may be deemed to have elected to treat the acquisition of the acquired corporation as an asset acquisition. These consistency requirements apply generally where the related acquisition of assets or of an affiliated corporation occurs within one year before or one year after the acquisition of the acquired corporation. Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of the acquired property is carried over, and other asset acquisitions pursuant to regulations. The purpose of the consistency requirements is to preclude selective disparate treatment for different acquired assets which have been part of the same corporate enterprise being acquired.

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[86] Under section 338, an acquiring corporation can generally elect by the 15th day of the ninth month after a qualified stock purchase (or within such other period as may be provided for in regulations) to treat an acquired subsidiary (i.e., the acquired corporation) as if it had adopted a plan of complete liquidation and then sold and repurchased all of its assets. The election is available only if, among other things, the acquiring company has acquired 80 percent or more of the stock of the acquired company in a taxable purchase.

[87] The basis of the acquired company's assets is stepped up to include the grossed up basis of the acquiring company in the stock acquired in the acquisition plus its basis in stock of the acquired corporation not purchased in the acquisition ("old and cold" stock), adjusted for the acquired company's liabilities, reflecting recapture tax liabilities, and other appropriate items. The gross up formula results in including in asset basis the value of stock not owned by the acquiring company, i.e., the value of any minority interest in the acquired corporation. The acquiring corporation may also have the current value of its "old and cold" stock included in asset basis by electing to recognize gain as if such stock were sold on the acquisition date.

The tax consequences of a taxable acquisition of stock, coupled with an election to treat the transaction as an acquisition of assets, are very similar to the tax consequences of a liquidating sale. In either case, the tax cost of recapture may outweigh the benefits of a step-up in basis of the assets involved. The parties can avoid that cost (and relinquish the benefits) by structuring the acquisition as a taxable stock acquisition and not making the election. In that case, as indicated, there would be no recapture and no change in asset basis.

## *F. Liquidations*

A liquidation generally involves a pro rata distribution of all the assets of the distributing corporation which, after winding up its affairs, would cease to exist.

### *1. Treatment of liquidating corporation*

In general, no gain or loss is recognized to a distributing corporation on the distribution of property in complete liquidation of such corporation (section 336). However, as in the case of liquidating sales, there is an exception to this rule for recapture items. In addition, certain nonstatutory doctrines, such as the tax benefit rule,[88] assignment of income principles,[89] and the clear reflection of income doctrine,[90] may override the nonrecognition rule applicable to liquidations.

This statutory nonrecognition rule is derived from the so-called *General Utilities* [91] doctrine. That doctrine is generally thought to preclude recognition of gain or loss to a corporation on the distribution of property with respect to its stock. Because a shareholder generally takes a fair market value basis in property received from the distributing corporation, application of the doctrine results in the elimination of the corporate level tax on appreciation that accrued prior to the distribution.

Since its statutory adoption in 1954, Congress has gradually limited the scope of the *General Utilities* doctrine.[92] It still applies, however, to liquidating distributions as well as to liquidating sales and the election to treat stock purchases as asset purchases.[93]

### *2. Treatment of shareholders*

*a. In general.*—As a general rule, amounts distributed to a shareholder in a complete liquidation of a corporation are treated as full payment in exchange for the shareholder's stock. Under this rule, no portion of the amount received is treated as a dividend (section 331). A shareholder's basis in property received in a complete liquidation of the distributing corporation is the fair market value of such property at the time of the distribution (section 334(a)).

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[88] *See Bliss Dairy, Inc.* v. *Commissioner,*—U.S.—(1983), 83-1 U.S.T.C. Par. 9229.

[89] *J. Ungar, Inc.* v. *Commissioner,* 244 F.2d 90 (2d Cir., 1957).

[90] *Jud Plumbing & Heating Co.* v. *Commissioner,* 153 F.2d 681 (5th Cir., 1946); *Standard Paving Co.* v. *Commissioner,* 190 F.2d 330 (10th Cir. 1951), *cert. denied,* 342 U.S. 860 (1951).

[91] *General Utilities & Operating Co.* v. *Helvering,* 296 U.S. 200 (1935).

[92] *See, e.g.,* the rules requiring recognition of gain on an ordinary nonliquidating distribution of appreciated property (section 311(d)). Further the recapture rules are fully applicable to corporate distributions and sales, including liquidating distributions and sales.

[93] *See* description of sections 337 and 338, *supra.*

*b. Special rule for liquidations of subsidiaries.*—Special rules apply to liquidations of 80 percent owned subsidiaries. Under these rules, the shareholder (*i.e.*, the parent corporation) does not recognize gain or loss on the receipt of property distributed to it in complete liquidation of the distributing corporation (section 332). In such a case, the shareholder generally takes a carryover basis in property received from the distributing corporation (section 334(b)) and succeeds to the tax attributes of the liquidated subsidiary (section 381).

*c. One-month liquidations.*—Under certain circumstances, a corporation holding appreciated property but having no earnings and profits can be liquidated without the recognition of gain by its shareholders (section 333). Specifically, in the case of one-month liquidations, if appropriate elections are made, an individual shareholder only recognizes gain to the extent of (1) such shareholder's pro rata share of the earnings and profits of the corporation, and (2) the excess of the amount of any money and value of any stock and securities received over the shareholder's ratable share of earnings and profits. For individuals, gain to the extent of the pro rata share of earnings and profits is treated as ordinary income; gain recognized in excess of that amount is treated as capital gain. Gain is recognized by a corporate shareholder only to the extent of the greater of (1) such shareholder's pro rata share of earnings and profits or (2) an amount equal to the amount of any money and value of any stock and securities received, and no part of such gain is treated as a dividend. A shareholder's basis in assets received in a one-month liquidation is a substituted basis (*i.e.*, the shareholder's basis in the stock of the liquidating corporation adjusted for any money received and gain recognized).

Section 333 treatment is available to shareholders other than corporations only if at least 50 percent of such shareholders make the election, and to corporate shareholders only if at least 80 percent of such shareholders make the election. However, a corporate shareholder owning stock possessing 50 percent or more of the voting power may not make the election and is excluded in determining the eligibility of other corporate shareholders.

Recently, the Internal Revenue Service has ruled that section 333 liquidation distributions may be made non pro-rata.[94] As a result, if applicable State corporation law does not otherwise provide, a distribution may be made other than in pro rata shares of the corporate assets.

### *3. Liquidating sales by corporations acquired in a C reorganization*

As discussed more fully above, special rules provide for nonrecognition of gain or loss to a corporation on a liquidating sale of assets (section 337). Further, under the general rule discussed above, no gain or loss is recognized to a liquidating corporation on the distribution of its assets to its shareholders (including the proceeds of any liquidating sales) (section 336).

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[94] Rev. Rul. 83-61, 1983-15, I.R.B. 5.

There is uncertainty under present law regarding whether a transferor corporation that transfers substantially all of its assets to an acquiring corporation in a C reorganization can obtain nonrecognition treatment on a sale of any property prior to its distribution to its shareholders of all of its assets. The Court of Claims has held that nonrecognition treatment under section 337 is not available with respect to the sale of stock received in the reorganization.[95] The 5th Circuit, however, has taken a contrary position.[96]

#### *4. Liquidation-reincorporations*

So-called liquidation-reincorporations may take a number of different forms. The simplest form is the liquidation to historic shareholders under section 336 followed, after an interval, by a reincorporation of the business assets under section 351. A second principal form involves the incorporation in a subsidiary of all or part of the business assets of a corporation followed by a liquidation of the parent corporation. Other forms also have been reported.[97] In each case, the purpose is to continue business operations in corporate form, while achieving the tax benefits of a liquidation: capital gain at the shareholder level on the receipt of the assets distributed in liquidation, nonrecognition at the corporate level, and step-up in basis for assets that continue to be employed in an ongoing corporate business, while withdrawing liquid assets from corporation solution.

No express provision specifically limits liquidation-reincorporations. However, liquidation-reincorporation transactions are sometimes classified as D reorganizations. Amendments contained in the Tax Reform Act of 1984 regarding the definition of the term "control" for purposes of determining whether a transaction constitutes a D reorganization, should significantly enhance the Service's authority to treat liquidation-reincorporations as D reorganizations.[98] In addition, liquidation-reincorporation transactions have been classified as F reorganizations,[99] or found not to satisfy the requirements for liquidation treatment.[100]

### *G. Collapsible corporations*

Gain to shareholders of a collapsible corporation on the sale or exchange of stock, on distributions in partial or complete liquidation, or on distributions otherwise taxable as long term capital gain, is converted into ordinary income (section 341(a)). No express rule converts gain on a redemption. Also, a collapsible corporation may not liquidate tax-free under section 333 or sell its assets tax-free in connection with a plan of liquidation under section 337.

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[95] *See FEC Liquidating Corp.* v. *United States*, 548 F.2d 924 (Ct. Cls. 1977).

[96] *See General Housewares Corp.* v. *United States*, 615 F.2d 1056 (5th Cir. 1980).

[97] For example, a corporation may sell all of its business assets to another commonly controlled corporation, and then liquidate. *American Manufacturing Co.* v. *Comm'r.* 55 T.C. 204 (1970).

[98] P.L. 98-369, section 64.

[99] *See, e.g., Davant* v. *Comm'r*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

[100] *Telephone Answering Service Company, Inc.* v. *Comm'r*, 63 T.C. 423 (1974), *aff'd* 546 F.2d (4th Cir. 1976).

Historically, collapsible corporations were pioneered by the movie and real estate industries. In one form of transaction, a corporation would be formed to produce a movie. The principal actors, producer, and director, among others, would receive stock of the corporation rather than any salaries they might earn or any share of the royalties received from the exhibition of the movie. After completion of production, a sale of the shares would be made to the studio which would cause the corporation to liquidate tax-free. The principals would recognize capital gain on the sale of the stock, thus converting ordinary income into capital gain.[101] In addition, the corporation would not recognize gain on the distribution of its assets in liquidation.

Collapsible corporations are defined by reference to the purpose for which the corporation is formed or availed of and the stock is sold. If the principal purpose of the corporation is to manufacture, construct, produce, or purchase property and, before the realization of income or gain on the property by such corporation, the shareholders plan to sell or exchange their stock, then the corporation will be a collapsible corporation. A presumption of collapsible status applies to a corporation whose property consists largely of appreciated ordinary income assets held for less than 3 years (section 341(c)).

Several limitations apply to the general rule. First, the rules apply only to 5 percent shareholders (including shareholders to whom such holdings are attributed) (section 341(d)(1)). Second, 70 percent of the gain realized must be from the collapsible assets (section 341(d)(2)).[102] Third, the stock sale or liquidation must take place within three years of when the corporation completed production, construction, or manufacture of the property (section 341(d)(3)). Fourth, unrealized gain or ordinary income of the property of the corporation (and certain shareholders and other corporations) must be at least 15 percent of the corporation's net worth. Fifth, if the corporation elects to recognize gain on the unrealized appreciation, the shareholders will not be taxed at ordinary income rates (section 341(f)). Complex relief provisions prevent collapsible corporation treatment if the unrealized appreciation on the corporate assets is limited (section 341(e)).

### *H. Distributions to shareholders*

#### *1. Treatment of distributing corporation*

Under section 311, a distributing corporation generally recognizes gain on a nonliquidating distribution of appreciated property with respect to its stock. No loss is recognized in any such distribution. In addition, there are a number of exceptions to the general rule. For example, gain is not recognized on certain distributions to certain noncorporate stockholders.[103] In addition, gain is not recognized on (1) certain distributions of stock of controlled corporations, (2) certain distributions in redemption to pay death taxes, (3) certain redemption distributions to private foundations, and (4) certain redemption distributions by regulated investment companies.

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[101] *See, e.g. Pat O'Brien* v. *Commissioner*, 25 T.C. 376 (1955).

[102] Regulatory authority was provided in the Tax Reform Act of 1984 pursuant to which all items of inventory and other property held for sale to customers may be treated as one item of property held for sale to customers in determining the scope of the 70 percent limitation. The collapsible corporation rules were also amended to require the corporation to realize at least two-thirds of the taxable income from collapsible property before it can be excluded from the collapsible corporation definition. P.L. 98-369, section 65.

### *2. Treatment of shareholders*

*a. Ordinary distributions.*—A distribution of property by a corporation to its shareholders is treated as a dividend to the extent that the distribution is out of current or accumulated (post-February 28, 1913) earnings and profits (section 316(a)). Distribution in excess of earnings and profits are first applied against the shareholder's basis for the stock. Distributions in excess of basis are treated as gain from the sale or exchange of the stock (section 301).

Generally, a shareholder must include the amount of a dividend in income (section 61(a)(7)). In the case of a cash dividend, the amount of the distribution is the amount of cash that is distributed. If a distribution is of property (other than cash), the amount of the distribution generally is the fair market value of the property (section 301(b)(1)).[104]

*b. Dividends-received deduction.*—Corporations, in general, are entitled to an 85 percent dividends-received deduction. A 100-percent dividends-received deduction is allowed on dividends from certain controlled corporations and dividends paid to small business investment companies. No deduction is allowed for dividends paid on stock held for less than 46 days (91 days in the case of certain preferred stock paying dividends for a period in excess of 1 year). The holding period is tolled during periods in which the holder has a right or obligation to sell the dividend paying stock or otherwise has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property.

*c. Redemption distributions.*—Generally, a redemption involves a distribution by a corporation to a shareholder of cash or other property in exchange for all or a portion of the shareholder's stock in the corporation. A redemption distribution generally is taxed to a redeeming shareholder as a dividend, unless a statutory exception applies to treat the redemption as a sale or exchange of the redeemed stock (section 302(a) and (b)(1)). The exceptions are for redemptions which (1) are not essentially equivalent to a dividend, (2) are substantially disproportionate, (3) result in complete termination of a shareholder's interest, or (4) are made to noncorporate shareholders in partial liquidations.

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[103] Gain is not recognized if the distribution is made with respect to qualified stock and (1) the distribution qualifies as a partial liquidation under section 302(b)(4), or (2) it is a qualified dividend. Stock is qualified stock if it is held by a person (other than a corporation) who, after the application of attribution rules, at all times during the lesser of the 5-year period ending on the date of the distribution, or the period during which the distributing corporation (or a predecessor corporation) was in existence, held at least 10 percent in value of the outstanding stock of the distributing corporation (or a predecessor corporation). A qualified dividend is a dividend if the property is (1) used by the distributing corporation immediately before the distribution in the active conduct of a trade or business, and (2) not described in section 1221(1) (relating to inventory and certain other property) or section 1221(4) (relating to certain accounts and notes receivable).

[104] In the case of a distribution to a corporate shareholder, the amount of the distribution is the lesser of (1) the fair market value of the property or (2) the adjusted basis of the property in the hands of the distributing corporation immediately prior to the distribution, increased by the amount of gain recognized to the distributing corporation on the distribution. Under section 311 as amended by the Tax Reform Act of 1984, gain is generally recognized to a distributing corporation on an ordinary nonliquidating distribution of appreciated property. Thus, in most cases, the amount of the distribution will be the fair market value of the property.

### *3. Distributions of stock of controlled corporations*

Special rules are provided in the case of distributions of stock of controlled corporations. Under section 355 of the Code, a stockholder of a distributing corporation generally recognizes no gain or loss on the receipt from such corporation of stock of a controlled corporation if the transaction satisfies certain requirements.

*a. Requirements for tax-free treatment.*—Generally, a distribution qualifies for tax-free treatment under this provision only if: (1) the distributing corporation distributes control of the controlled corporation; (2) the distribution is accomplished for a substantial and bona fide business reason germane to the business of either the distributing or controlled corporation; (3) immediately after the distribution, the distributing corporation and the controlled corporation are each engaged in, or treated as being engaged in, the active conduct of a trade or business; and (4) the transaction is not used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both. The mere fact that the stock of either corporation is sold or exchanged after the distribution is not to be construed to mean that the transaction was used as such a device unless the sale or exchange was prearranged.

*b. Device test.*—The function and scope of the device test described above is uncertain. Proposed regulations state that a distribution that is substantially pro rata among the distributing corporation's shareholders is more likely to be undertaken as a device to distribute earnings and profits than one that is not pro rata.[105] Sales of stock, whether or not prearranged, are evidentiary as to the existence of such a device under the proposed regulations, and the nature and use of the assets of both corporations following the distribution may indicate a device even in the absence of a sale. The proposed regulations in this area have been published for over 8 years, but have not yet been finalized.

### *4. Earnings and profits*

The term "earnings and profits" is not defined in the Internal Revenue Code. It is, however, intended to provide a measure of the earnings of a corporation available for distribution to the corporation's shareholders. As noted, to the extent the amount of a distribution exceeds the corporation's earnings and profits, the shareholders are entitled to return of basis and capital gain treatment. The concept of earnings and profits also has special significance in the case of certain foreign corporations (see discussion below).

Certain rules for computing earnings and profits are provided in the Code (section 312). In general, earnings and profits are computed by making certain adjustments to taxable income. For example, interest on State and municipal obligations exempt from tax is added to taxable income in computing earnings and profits (Treas.

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[105] Proposed reg. section 1.355-2(c), published in the Federal Register on January 21, 1977.

Reg. section 1.312-6(b)). Further, certain deductions allowed in computing taxable income are not allowed in computing earnings and profits. For example, certain construction period carrying charges that are deductible for taxable income purposes are not deductible for earnings and profits purposes (section 312(n)). Finally, certain deductions not permitted in computing taxable income (*e.g.*, a deduction for dividends paid) are allowed in computing earnings and profits.

*a. Impact of dividend distributions.*—Generally, the distribution of a dividend reduces the distributing corporation's earnings and profits by the amount of the distribution. In the case of a distribution of appreciated property, earnings and profits are increased by an amount equal to the excess of the fair market value of the property over the distributing corporation's basis in the property.

*b. Impact of distribution of stock of controlled corporation.*—If the distribution is accomplished as part of a D reorganization, the earnings and profits of the distributing corporation immediately before the transaction are allocated between the distributing corporation and the controlled corporation. If the distribution is not a part of a D reorganization, the earning and profits of the distributing corporation are decreased by the lesser of: (1) the amount by which its earnings and profits would have decreased if the distribution were part of a D reorganization; or (2) the net worth of the controlled corporation (Treas. Reg. section 1.312-10(b)).

### *I. Varying definitions of "Control"*

Section 60 of the Tax Reform Act of 1984 amended the stock ownership requirements for corporations to be considered members of an "affiliated group." As amended, the test generally requires the ownership of at least 80 percent of the voting power and 80 percent of the value of each member's stock. For this purpose, certain preferred stock is excluded.

In contrast, the control requirement applicable to the reorganization rules, other than that applicable to D reorganizations, requires 80 percent of the voting power and 80 percent of the total number of shares of all other classes of stock, including preferred stock. This requirement applies as well for tax-free transfers to controlled corporations. A similar control definition applies for tax-free liquidations of subsidiaries and for purposes of section 338, except that for those provisions, certain perferred stock is not counted.[106]

### *J. Rules determining the basis of stock in subsidiary corporations—relationship of stock basis to subsidiary asset basis*

As described above, an acquisition of a subsidiary may take the form of either a stock acquisition or an asset acquisition. Thus, the gain or loss to be realized and recognized in an acquisition will often depend upon the parent's basis in the stock of the subsidiary and the subsidiary's basis in its assets. When the two differ, significant discontinuities may result in an acquisition transaction.

Despite this, the acquisition of a subsidiary will rarely result in conformance of "outside" stock basis with "inside" asset basis. For example, in a B reorganization, the acquiring corporation obtains a basis in the stock of the acquired subsidiary determined by the historical basis of the former shareholders of the acquired subsidiary. That historical stock basis may vary considerably from the "inside" asset basis of the subsidiary. As another example, an acquisition of assets by an existing subsidiary may result in "inside" asset basis equal to fair market value. That basis may significantly differ from the "outside" stock basis in the subsidiary held by the parent corporation.

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[106] Sections 104(d)(4) and (5) of S. 814, the Technical Corrections Act of 1985 recently introduced by Senators Packwood and Long, would remedy some of the discontinuities in this area.

In addition, except where the corporations file a consolidated return, there is no mechanism under current law to conform "inside" and "outside" basis to reflect the earnings of the subsidiary. For example, undistributed income of the subsidiary will generally increase its inside asset basis over time, but such increase will not be reflected in the parent's outside basis in the subsidiary stock. Thus, current law may, in certain cases, exacerbate the discontinuities created when "inside" basis and "outside" basis are defferent.

Where consolidated returns are filed, the regulations require complex adjustments to the parent's basis in its stock of the subsidiary to reflect the subsidiary's earnings and profits (Treas. Reg. section 1.1502-32). Earnings and profits exceed taxable income in many cases, however, often causing the parent's outside stock basis to exceed the subsidiary's inside basis, which generally will reflect taxable income. Further, the consolidated return adjustments do not eliminate the original discrepancy created upon the acquisition of the subsidiary or its assets.

### *K. Treatment of Foreign Corporations*

Two special rules relate to transactions involving foreign corporations.

#### *1. Transfers of property outside the United States*

As described above, certain transfers of appreciated property to a corporate transferee that are made in connection with a corporate organization, reorganization, or liquidation, can be made without recognition of gain to the transferor or its shareholders. A special rule applies, however, if the transfer is made out of the United States (an "outbound transfer") to a foreign corporation (section 367). As modified by the Tax Reform Act of 1984, a foreign corporation is generally not considered a "corporation" for purposes of determining the extent to which gain is recognized on an outbound transfer. A general exception is provided for transfers of property for use in the active conduct of a trade or business outside the United States. Special rules are provided in the case of (1) the transfer of certain "tainted" assets (*e.g.*, inventory, accounts receivable, installment obligations) identified in prior IRS guidelines;[107] (2) the incorporation of certain foreign branches that have operated at a loss; and (3) the transfer of certain intangibles.

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[107] *See, generally*, Rev. Proc. 68-23, 1968-1 C.B. 821.

### 2. Gain from sale or exchange of stock in certain foreign corporations

Under current law, gain on the disposition of stock in a foreign corporation by a U.S. person owning 10 percent or more of the corporation's voting stock may be treated as a dividend (section 1248). The rule is designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation ("CFC") (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own 10 percent or more of such stock), and then, rather than repatriating the earnings in the form of dividends taxable as ordinary income, disposing of the stock at capital gain rates for a price that reflects the accumulated earnings. The provision recharacterizes gain as dividend income to the extent of the foreign corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a CFC. The rule applies to certain nonrecognition transactions as well as taxable dispositions of stock.

## L. Limitations on net operating loss carryovers and other tax attributes

### 1. Net operating loss deduction

Although the Federal income tax system generally requires annual accounting, taxpayers are permitted to carry net operating losses (NOLs) forward for use against future income (section 172). In general, after giving effect to a 3-year carryback period, a corporate taxpayer is allowed to carry NOLs forward to each of the 15 taxable years following the year of loss. Any portion of the loss remaining after the termination of the 15-year carryforward period expires.

### 2. Carryovers to successor corporations

In general, as described above, statutory rules provide for the carryover of tax attributes (including NOL carryovers) from one corporation to another in certain tax-free reorganizations and in the case of a tax-free liquidation of an 80 percent owned subsidiary (section 381(a)).

In addition to NOL carryovers, other tax attributes that carry over from one corporation to another include: unused business credits that can be carried forward under section 39; unused research credits that can be carried forward under section 30(g)(2); unused foreign tax credits that can be carried forward under section 904(c); and net capital losses that can be carried forward under section 1212.

### 3. Acquisitions to evade or avoid tax

In the case of certain acquisitions of control of another corporation, or certain acquisitions of assets, any deduction (including an NOL deduction) may be disallowed if the principal purpose for the acquisition is tax avoidance (section 269).

### *4. The Libson Shops doctrine*

In *Libson Shops, Inc.* v. *Koehler,*[108] a case decided under the 1939 Code, the Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. *Libson Shops* involved a merger of sixteen commonly owned corporations into one corporation. The corporation representing the combined enterprises then sought to utilize the pre-merger NOLs of three of the merged corporations against the post-merger income of the other thirteen operations. The NOL carryover was denied on the ground that the income against which the deduction was claimed was not produced by the same businesses that incurred the loss.

There is uncertainty as to whether the *Libson Shops* doctrine has any continuing vitality as a separate nonstatutory test for determining the availability of NOL carryovers in any situation.

### *5. Special limitations on NOLs and other attributes*

Present law provides special limitations on the availability of NOL carryovers after a purchase (or other taxable acquisition) of stock and after a tax-free reorganization (section 382). Section 383 incorporates by reference the same limitations as those contained in section 382 for other tax attributes such as the investment credit carryover, the foreign tax credit carryover, and carryovers of net capital losses.

*a. Taxable purchases.*—The rule for purchases applies if one or more of the ten largest shareholders increase their common stock ownership, within a two-year period, by 50 percentage points or more (except where the stock is acquired from a related person) (section 382(a)). Even where the stock ownership change is satisfied, the rule will not apply if the corporation continues to conduct a prior trade or business or substantially the same kind of business after the purchase. If the stock ownership change is met and a historical business of the corporation is not continued, NOLs are completely lost.

Thus, under the purchase rule, a 100 percent change in ownership does not result in any limitation on the availability of NOLs so long as the old business is continued and section 269 is not applicable. This may permit new profitable businesses to absorb NOLs incurred by the former owners. Further, an acquisition of control of a loss corporation through the issuance of new stock does not constitute a purchase under present law and therefore avoids the special limitations.

*b. Tax-free reorganizations.*—In the case of a tax-free reorganization, the special limitations apply only if there is an 80 percent change in the ownership of the loss corporation (section 382(b)). Thus, assuming section 269 is not applicable, NOL carryovers are allowed in full if former owners of the loss corporation receive stock representing 20 percent or more of the value of the acquiring corporation (not counting nonvoting preferred stock). For each percentage point less than 20 percent received by the loss corporation shareholders, the NOL carryover is reduced by five percent. Under section 382(b), it is immaterial whether the business of the loss corporation is continued after a reorganization.

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[108] *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957).

The reorganization rule can be circumvented by using a subsidiary to acquire the loss corporation's assets in exchange for stock of a parent corporation, since the 20 percent test is applied by treating the loss corporation shareholders as receiving stock in the subsidiary equivalent in vaule to the stock they receive in the parent corporation. Full preservation of NOL carryovers can also be obtained by issuing participating or voting preferred stock to the shareholders of a loss corporation, so long as the value of the stock is at least 20 percent of the value of the acquiring corporation's stock. Further, tax-free stock-for-stock acquisitions (under section 368(a)(1)(B)) are outside both the reorganization rule and the purchase rule.

### *6. Effect of section 269 and the Libson Shops doctrine*

Present law injects an element of uncertainty into acquisitive transactions because NOL carryovers are subject to disallowance under section 269 and, to a lesser extent, the *Libson Shops* doctrine, even if the special limitations are avoided. Commentators have argued that the effect of this uncertainty is to discount the price for a loss corporation to take account of the possibility that the NOL carryover will be reduced or wholly disallowed, resulting in a windfall to the acquiring corporation if the NOLs are ultimately allowed.

### *7. Consolidated return regulations*

The consolidated return regulations impose additional limitations on NOLs. For example, if more than 50 percent of the fair market value of the stock of the common parent of an affiliated group changes hands by purchase, NOLs of members of that group may be carried over only against subsequent income of those members (Treas. Reg. section 1.1502-21(d)). This is the consolidated return change of ownership ("CRCO") rule.

In addition, if the stock of a loss corporation is acquired by a member of an affiliated group filing a consolidated return, NOLs of the loss corporation may be carried over only against subsequent income of that corporation, and not against income of other group members (Treas. Reg. section 1.1502-21(c)). This is the separate return limitation year ("SRLY") rule. Rules (the "reverse acquisition" rules) are also provided to assist in applying the SRLY rule (Treas. Reg. section 1.1502-75(d)(3)).

Subject to whatever limitation section 269 may impose, these rules can be avoided by transferring profitable businesses or assets to the acquired corporation or corporations.

### *8. 1976 Act amendments*

The Tax Reform Act of 1976 extensively revised the statutory provisions for special limitations on NOL carryovers, providing more nearly parallel rules for taxable purchases and tax-free reorganizations. The 1976 Act amendments have been postponed for a number of years, and are now scheduled to become effective beginning in 1986. Until the 1976 Act amendments take effect, present law continues to govern.

*a. In general.*—As enacted, the 1976 Act eliminates the test of business continuity applicable under the purchase rule; thus, the 1976 Act amendments focus solely on changes in stock ownership. The threshold for changes in stock ownership was changed from 50 percentage points (80 points in the case of tax-free reorganizations) to more than 60 percentage points. Thus, for purposes of both the purchase rule and the reorganization rule, the loss corporation shareholders must retain a 40 percent continuing interest in order for NOL carryovers to be allowed in full. For each percentage point (or fraction thereof) of continuing interest less than 40 percent but not less than 20 percent, the NOL carryover is reduced by 3½ percentage points. For each percentage point (or fraction thereof) of continuing interest less than 20 percent, the NOL carryover is reduced by 1½ percentage points. Thus, a 100 percent change in ownership results in total disallowance of loss attributes whether or not the historic business is continued.

The 1976 Act also introduced the concept of "participating stock" (*i.e.*, stock that represents an interest in the corporation's growth potential) into the law, in order to prevent acquiring corporations from using certain preferred stock to circumvent the rules for determining whether a change in ownership has occurred. Under the amendments, the lesser of the participating stock or the percentage of all stock is taken into account in determining the extent of the loss corporation shareholders' continuing interests.

The 1976 Act did not repeal the provision (section 269) relating to acquisitions for tax avoidance purposes. However, it was intended that section 269 would not be applied to disallow a loss carryover permitted under the specific rules of section 382 in the absence of a scheme or device to circumvent the purpose of the carryover restrictions.[109]

*b. Taxable purchases.*—The 1976 Act amendments expanded the category of transactions that are treated under the purchase rule to include capital contributions that increase a shareholder's percentage ownership. The shareholders taken into account under the 1976 amendments are those who hold the 15 largest percentages of the total value of the corporation's stock on the last day of its taxable year. The relevant points for determining the extent of any ownership change as of the end of any taxable year are the beginning of the year under examination and the beginning of the first and second preceding taxable years.

*c. Tax-free reorganizations.*—Under the 1976 Act amendments, stock-for-stock acquisitions (under section 368(a)(1)(B)) are made subject to the reorganization rule. Other provisions deal with attempts to avoid the limitation by buying the loss company's stock before the reorganization and cases where the loss company is a subsidiary of a corporate party to a reorganization.

### *M. Treatment of S corporations*

When a qualifying corporation makes an election to be treated as an S corporation, corporate income generally becomes subject to a single, shareholder level tax. In general, a corporation qualifies for the election only if it has not more than 35 shareholders who are individuals other than nonresident aliens, estates, and certain trusts. In addition, it may not have more than 1 class of stock, may not be a member of an affiliated group of corporations, and may not be within certain excluded categories of corporations.

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[109] *See S. Rep. No. 94-938*, 94th Cong. 2d Sess. 206 (1976); H. Rep. No. 94-1515, 94th Cong. 2d Sess. 450 (1976).

Certain exceptions apply to the exemption from the corporate level tax. A tax is imposed on a portion of the net passive income of an S corporation for any year during which its passive investment income exceeds 25 percent of gross receipts and it has subchapter C earnings and profits as of the close of the year. After three consecutive years during which these conditions exist, the election is terminated. An S corporation has subchapter C earnings and profits if it had accumulated earnings and profits as of the time the election was made which remain undistributed. In addition, the corporation is taxed on net capital gain in excess of $25,000 in certain cases where the subchapter S election has not been in effect for the 3 preceding years.

### *N. Treasury Department proposal for fundamental tax reform*

In its November, 1984 report to the President on fundamental tax reform,[110] the Treasury Department included the following proposals affecting the taxation of corporations and their shareholders:

#### *1. Dividends-paid deduction*

The proposal would allow a dividends-paid deduction equal to 50 percent of distributed income that has borne the corporate level tax. This would be combined with a 50 percent dividends-received deduction allowed to corporate shareholders. These rules in general would subject only 50 percent of the total corporate income to the corporate income tax. These rules would replace the 100 percent and 85 percent dividends-received deduction of present law and are intended to (1) alleviate the bias in favor of debt financing, (2) reduce the significance of the distinction between debt and equity, and (3) promote greater efficiency in the use of corporate earnings and capital. The proposal would be phased in over a number of years commencing in 1987.

#### *2. Large limited partnerships*

The proposal would require limited partnerships to be treated as corporations for tax purposes if, at any time during the taxable year, there are more than 35 limited partners. The test would be applied by looking through other pass-through entities holding an interest in the partnership. When a partnership exceeds the limitation, it would be treated as a termination of the partnership and a contribution of its assets to a newly-formed corporation. The proposal is intended to (1) reduce the ability of an entity with the legal characteristics of a corporation to provide pass-through tax treatment, (2) provide more extensive and consistent limitations on losses from passive investments, (3) retard tax-motivated shifts from the corporate sector to the partnership sector, and (4) ease ad-

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[110] "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President" (November, 1984).

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ministrative and audit problems of large limited partnerships. The proposal would be effective in 1986 for new partnerships and in 1990 for partnerships organized before introduction of the proposal.

### *3. Repeal special reorganization rules*

The proposal would terminate the rules adopted in the Economic Recovery Tax Act of 1981 that permit financially troubled thrift institutions to be acquired in a tax-free reorganization without regard to the continuity of interest requirement applicable to other types of entities. Under these rules, the tax attributes, including its net operating losses, of the failing thrift institution are made available to the acquiring corporation by acquiring the assets and assuming the liabilities of the thrift institution. In addition, the exclusion from income of payments by the Federal Savings and Loan Insurance Corporation in connection with these reorganizations would be terminated. These proposals would be effective in 1986.

### *4. Other*

The Treasury Department proposals do not otherwise address the treatment of corporations and shareholders under present law. However, the report acknowledges the importance of efforts in other sectors to rationalize and simplify current rules and affirms the Treasury Department's interest in and support of such efforts. The report states:

> Thus, in general, no proposals has been made regarding the taxation of corporate liquidations, reorganizations, or the carryover of corporate tax attributes, including net operating losses. The rules in these areas are frequently cited as in need of reform, and important work has been undertaken in a number of sectors to rationalize and simplify current law. The Treasury Department is interested in and supportive of efforts to reform current rules for the taxation of corporations and shareholders. No inference to the contrary should be drawn from the fact that these issues have not been addressed in the Treasury Department proposals.[111]

## III. REASONS FOR CHANGE

### *A. General reasons for change*

As described above and highlighted through examples below, the current law of Subchapter C is seriously flawed. The "law" consists of a series of rules, some statutory and others of judicial origin, which, when taken together, lack consistency, are unnecessarily complex, and are often subject to manipulation. By providing uncertain and often capricious tax consequences to business transactions, the law inadequately addresses the needs of businessmen, their corporations, and their investors. Moreover, by being inconsistent and subject to manipulation, the law is biased, at times encouraging tax-motivated transactions, and at times discouraging or making less efficient legitimate business dealings. It is far from clear whether the bias of current law serves any particular Congressional policy goal. Further, it is highly questionable, given the complexity and uncertainty of current law, whether any Congressional policy initiatives could effectively be implemented if the present structure of Subchapter C were retained.

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[111] *Id.*, Vol. II at 144.

The inadequacy of current law presents three interrelated principal reasons for change. First, current law needs to be made more rational and consistent, thereby providing greater certainty and less complexity in the area. For example, under current law, an "A" reorganization (statutory merger or consolidation) may involve a significant amount of cash consideration, a "B" reorganization (stock-for-stock acquisition) cannot have any cash consideration, and a "C" reorganization (stock-for-assets acquisition) may involve a small amount of cash consideration. No policy justification can be found for these and other distinctions. The bill would propose to eliminate artificial distinctions of that sort.

Second, current law should be made more neutral, providing less influence over, and less interference with, general business dealings. Current law, for example, creates a bias in favor of a liquidation of a corporation by providing special tax treatment in that situation. Consequently, in the right circumstances, a merger or an acquisition may be motivated, in whole or in part, by the favorable tax consequences to the target corporation in the transaction, or by the favorable tax attributes obtained by the acquiring corporation in the transaction. In addition, in many other cases, current law requires tax-*structured* deals (whether dictating the use of certain kinds of consideration, formation of holding companies, or other non-economic steps) which create unnecessary inefficiencies from a business standpoint. This bill would propose eliminating many of those biases and non-economic requirements.

Finally, current law needs to be reformed and made less subject to manipulation. The Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984 made some strides to reform the area and to foreclose unintended loopholes. However, problems still exist. For example, current law may permit a corporation to multiply its losses by means of the simple expedient of organizing new subsidiaries. Current law may also permit the complete avoidance of corporate or shareholder level tax in certain types of acquisitions, with the acquiring party obtaining a cost basis in the assets acquired. This bill would eliminate those possibilities.

*B. Detailed reasons for change*

*1. Problems relating to the definition of "reorganization"*

As outlined below, the different definitional requirements for a "reorganization" create much of the complexity in current law. Some of these requirements are based on statutory rules, and others are of judicial origin. There are persuasive arguments for standardizing and making uniform these rules, as well as the rules prescribing the various forms of taxable acquisitions.

*a. Boot as consideration.*—No consideration other than voting stock is permitted in a B reorganization. A C reorganization permits a limited amount of boot (up to 20 percent of the total consideration). No specific statutory rule limits the amount of boot in an A reorganization, although the continuity of interest doctrine imposes some limitation. In certain cases, the assumption of liabilities may be treated as boot and in certain other cases, it may not be.

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No policy justification can be found for maintaining these disparate rules in what are essentially economically equivalent transactions.

*b. Voting stock as consideration.*—The qualifying consideration in a B or C reorganization, or a reverse triangular merger, must be *voting* stock. No such limitation applies in an A reorganization or a forward triangular merger.

*c. Stock of corporation in control of acquiring corporation as consideration.*—If structured correctly, as many as three tiers of acquiring corporations may be involved in an acquisitive transaction without affecting reorganization status. It is unclear from the statute whether reorganization status can be preserved if the structuring is not proper and, for example, the acquiring corporation is in the third tier of corporations, although the IRS has ruled favorably on the question. It is also questionable whether stock of a corporation involving more remote ownership may be used. This introduces unnecessary rigidity when a target corporation is acquired by one or more members of an affiliated group.

*d. Subsidiary mergers.*—Different rules apply depending upon the direction of a subsidiary merger under section 368(a)(2)(D) or 368(a)(2)(E). Further, the "substantially all" limitation (discussed below) applies to subsidiary mergers even though they are nominally classified as A reorganizations. Thus, the requirements for a subsidiary merger are closer to C reorganizations than A reorganizations. The different, inconsistent, and complex requirements applicable to an acquisition through a subsidiary have been described as impossible to justify.[112]

*e. "Substantially all" requirement.*—As noted, C reorganizations and subsidiary mergers impose a "substantially all" limitation. Certain D reorganizations have the same requirement. No such limitation is contained in an A reorganization. Thus, for example, a predisposition of assets prior to an acquisition may cause the transaction to fail as a C reorganization,[113] but as an A reorganization.[114]

Furthermore, the exact meaning of "substantially all" is unclear. Ruling guidelines applicable to C reorganizations and subsidiary mergers establish a 70 percent of gross assets and 90 percent of net assets standard. Case law in the D reorganization area has permitted a much smaller percentage of assets to qualify as "substantially all."[115]

*f. Predisposition of assets.*—As described above, a predisposition of assets prior to an acquisition may affect qualification as a C reorganization or a subsidiary merger. No such problem generally occurs in an A or B reorganization.

*g. Overlap issues.*—With the exception of a transaction qualifying as both a C and D reorganization where D reorganization status is mandated, the statute does not provide rules settling overlap questions between and among reorganization provisions. This creates substantial uncertainty where the tax consequences of the transac-

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[112] American Law Institute, *Federal Income Tax Project: Subchapter C* (1982) at 28.

[113] *Helvering* v. *Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir., 1938), *cert. denied*, 305 U.S. 605 (1938).

[114] *Commissioner* v. *Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

[115] *See, e.g., Smothers Company* v. *United States*, 642 F.2d 894 (5th Cir. 1981).

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tion depend upon the specific category of reorganization that is satisfied.

*h. Continuity of interest requirement.*—This judicial doctrine is of uncertain application. The portion of total consideration consisting of an equity interest must be a "material part" of the consideration for the transferred assets.[116] However, where 38 percent of the consideration consisted of callable preferred stock, this requirement has been considered satisfied.[117]

Moreover, the assumption underlying the limitation is that preferred treatment should be provided to consideration in the form of stock because stock represents a continuing commitment by the shareholders of the target corporation in the risks of the target business after the acquisition. This policy goal may not be effectively implemented where, for example, preferred stock subject to early redemption is provided tax-free treatment whereas a long-term creditor interest is not. In that case, the preferred stock may represent much less of a continuing commitment in the business risks of the target corporation than the long-term creditor interest.

Further, the IRS has indicated for ruling purposes that continuity of interest is important both before and after an acquisition.[118] As noted, at least one case has held that continuity of interest is not present if the target corporation shareholders dispose of the stock received in the transaction pursuant to a prearranged plan.[119] It is unclear whether significant preacquisition arbitrage activity will preclude tax-free treatment of the subsequent acquisition.

Finally, the existence of continuity of interest may depend upon the nature of the interest in the target corporation surrendered by the target investor. For example, in a merger of a stock savings and loan association into a mutual savings and loan association, where the former shareholders of the target corporation received passbook savings accounts and certificates of deposit of the acquiring entity (the only form of "equity" available in the acquiring entity), the Supreme Court held that the continuity of interest requirement was not satisfied.[120] In contrast, where interests in a mutual savings and loan association were exchanged for interests in an acquiring mutual savings and loan association, the IRS held that continuity of interest was satisfied.[121]

*i. Continuity of business enterprise and business purpose doctrines.*—Two other non-statutory requirements for a corporate reorganization are the business purpose and continuity of business enterprise doctrines. The regulations were recently amended to provide that the trade or business of the target corporation must be continued, or a "significant portion" of the target company's historic business assets must be used in a trade or business following the acquisition, in order to satisfy the continuity of business enterprise requirement.[122] Some uncertainty surrounds the exact parameters of these tests.

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[116] *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378 (1935).

[117] *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935).

[118] Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

[119] *See McDonald's Restaurants of Illinois, Inc.* v. *Commissioner*, 688 F.2d 520 (9th Cir. 1982).

[120] *Paulsen* v. *Commissioner*, 53 U.S.L.W. 4029 (January 8, 1985).

[121] Rev. Rul. 69-3, 1969-1 C.B. 103.

[122] Treas. Reg. sec. 1.368-1(d), as amended by T.D. 7745 (12/30/80).

*j. Linking of shareholder level consequences to corporate level consequences and to tax treatment of other shareholders.*—Current law links the shareholder level consequences of a reorganization to the corporate level consequences and to the tax treatment of other shareholders in the transaction. This produces a number of anomalous results.

For example, a transaction that fails reorganization status at the corporate level (*e.g.*, because a predisposition of assets causes failure of the "substantially all" requirement) will therefore be fully taxable at the shareholder level, even though the shareholders of the target corporation all receive stock in the acquiring corporation. This is contrary to the policy decision that stock in an acquiring corporation should entitle a target shareholder to tax-free treatment.

As another example, failure to satisfy a shareholder level requirement (*e.g.*, continuity of interest) will make a transaction completely taxable at the corporate level. This recently occurred in the case of *Paulsen* v. *Commissioner*[123] where, because of failure of continuity of interest, a merger of a stock savings and loan association into a mutual savings and loan association was a taxable transaction. A more rational system would permit the corporate merger to be tax-free so long as the acquiring entity obtained only a carryover basis in the assets transferred.

A final example is illustrated by *May B. Kass* v. *Commissioner.*[124] In that case, a single minority target shareholder who received solely stock in the acquiring corporation in an acquisition, was required to treat the exchange as a taxable one because of failure of the overall transaction to satisfy continuity of interest. No apparent policy reason can be found to justify linking the tax consequences for one shareholder of a target corporation to the tax treatment of other such shareholders. Furthermore, as described earlier, the well-advised may, in any event, be able to obtain nonrecognition treatment for the minority shareholder through the formation of a holding company.[125]

*k. Whipsaw.*—As described earlier, the complexity of the reorganization definition creates many whipsaw possibilities against the government or the taxpayer. The statutory scheme is replete with reasons for different taxpayers to characterize a transaction differently: capital gain or dividend treatment of boot received by target shareholders; taxable or tax-free treatment of stock received by such shareholders; taxable or tax-free treatment to the target corporation itself; carryover or cost basis treatment to the acquiring corporation; survival or termination of attributes of the target corporation. The risk of whipsaw has often led the IRS to decline to rule in a number of areas, producing additional uncertainty.

Explicit electivity of the tax result of a transaction, and separation of corporate and shareholder level tax consequences, would do much to minimize the whipsaw possibilities.

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[123] *Paulsen* v. *Commissioner*, 53 U.S.L.W. 4029 (January 8, 1985).

[124] *May B. Kass* v. *Commissioner*, 60 T.C. 218 (1973), *aff'd without opinion*, 491 F.2d 749 (3d Cir. 1974).

[125] *See* Rev. Rul. 84-71, 1984-1 C.B. 106.

### *2. Problems presented by the General Utilities doctrine*

In some respects, many of the problems relating to the definition of "reorganization" described above are tied to the so-called *General Utilities* doctrine. For example, failure to provide a symmetrical system at the corporate level for determining the availability of carryover basis or cost basis to the acquiring corporation causes in large part the linkage of shareholder level and corporate level tax consequences. Repeal of *General Utilities* would eliminate the need for restrictions of that sort. Other problems created by the *General Utilities* doctrine include the following:

*a. Bias in favor of "liquidating" transactions.*—The doctrine provides for more generous tax treatment in liquidating transactions than for sales and distributions by ongoing corporations. The doctrine insulates from corporate level tax not only capital gain but also ordinary income that is not subject to recapture. The preference creates strong incentives to structure transactions as "liquidations," and may encourage merger and acquisition activity. No clear policy goal is achieved by providing this preference.

Moreover, the preference places great pressure on anti-abuse rules that have been developed (described below). For example, liquidation-reincorporation transactions must be carefully policed because of the preference.

*b. Need for complex anti-avoidance rules.*—The *General Utilities* doctrine establishes that the "price" to be paid for a basis step-up at the corporate level is a shareholder-level tax. This lack of symmetry has spawned a number of tax avoidance schemes that have required complex statutory and judicial responses. These include:

*(i) Collapsible corporation rules.*—The complexity of these rules is legendary. The American Law Institute has described the collapsible corporation rules as "characterized by a pathological degree of complexity, vagueness, and uncertainty." [126] One sentence of the provision is widely cited as the longest sentence in the entire Tax Code, and is twice as long as the Gettysburg Address.

*(ii) Liquidation-reincorporation concerns.*—The D reorganization is the principal tool available to the IRS to combat efforts to combine a step-up in basis at the corporate level with a bail-out of earnings at capital gains rates. The definition of a D reorganization, however, is not sufficiently comprehensive to encompass all such transactions. For example, failure to make the required distribution of stock or securities may cause a transaction to fail to be characterized as a D reorganization.

*(iii) Recapture rules.*—The recapture rules are designed to compensate, in part, for the lack of symmetry created by the *General Utilities* doctrine. But the recapture rules are not comprehensive in application. For example, section 1250 recapture is limited to the recovery of depreciation claimed in excess of straight-line depreciation. Further, recapture under section 1254 is limited to certain intangible drilling costs deducted since 1976.

In addition, certain depletable or amortizable items are not subject to recapture at all. For example, no recapture is required of cost or percentage depletion deductions. Insurance contracts subject to amortization are not subject to recapture.

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[126] American Law Institute, *Federal Income Tax Project: Subchapter C* (1982) at 111.

Finally, except to the extent of the LIFO recapture amount, the disposition of inventory in a liquidating transaction is not subject to recapture and ordinary income attributable to such disposition may go untaxed.

*(iv) Tax benefit rule.*—The tax benefit rule overrides the *General Utilities* doctrine, and may apply where the recapture rules are deficient. As evidenced by the recent Supreme Court case in *Bliss Dairy,*[127] however, the exact scope of the doctrine is uncertain. Still unresolved, for example, is the proper treatment of previously deducted reserves of an insurance company that is acquired in an "assumption reinsurance" transaction.

*(v) Assignment of income and clear reflection of income principles.*—These principles have also developed to avoid the mismatching of corporate level step-up with shareholder-level gain.

*(vi) Consistency rules.*—The latest illustration of the complexity spawned by the *General Utilities* doctrine are the consistency rules under section 338.[128] The consistency rules were developed in response to concern that selectivity of tax consequences on an item-by-item basis provided excessive opportunity for tax avoidance.[129] Cost basis could be selected for those assets having little or no recapture tax liability. Carryover basis could be selected for other assets.

A repeal of *General Utilities* and the imposition of a full corporate tax as the cost for a step-up in basis at the corporate level relieves much of the need for strict consistency rules. As described below, a much simpler and more streamlined consistency requirement can be maintained if the *General Utilities* doctrine is repealed.

*c. Churning and misallocation of purchase price.*—The lack of symmetry provided by the *General Utilities* doctrine also creates tax incentives to dispose of assets and raises controversies as to the proper allocation of purchase price. Where the cost of a corporate level step-up in basis is not measured by a tax on the corporate level appreciation in value, churning opportunities arise. As described above, the recapture provisions provide an imperfect set of rules for monitoring churning problems. In addition, repeal of *General Utilities* would significantly reduce the incentive to misallocate total purchase price among the assets acquired.

*d. Liquidation/reorganization uncertainty.*—As noted, it is uncertain under present law whether a transferor in a C reorganization may also obtain nonrecognition treatment on sales of property prior to the required distribution of assets to the transferor's shareholders.[130] Repeal of the *General Utilities* doctrine would eliminate this conflict.

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[127] *Bliss Dairy* v. *United States*—U.S.—(1983), 83-1 U.S.T.C. Para. 9229.

[128] The Internal Revenue Service recently published 154 pages of Temporary Regulations under section 338. T.D. 8021, 50 *Federal Register* 16402 (April 25, 1985). A substantial portion of the regulations deals with the consistency requirements.

[129] *See* Hearing on the Tax Treatment of Corporate Mergers and Acquisitions before the Committee on Finance, United States Senate, 97th Cong., *2d* Sess. (July 15, 1982), testimony of David G. Glickman, Deputy Assistant Secretary (Tax Policy), Department of Treasury. Mr. Glickman stated: "The ability to pick and choose as to asset basis (with the present attendant tax consequences) has been abused and has provided an incentive for certain corporate acquisitions. Since potential cost recovery deductions make some assets more valuable to buyers than to sellers, the tax laws provide some incentive for the sale of assets. Where some desired assets are acquired with a basis step-up, while other desired assets are acquired without triggering any tax detriment, the incentive escalates. If P desires to make an acquisition from (or of) T, P should take the bad with the good with respect to the property acquired." HG 97-106 at 84.

*e. Remaining tax avoidance possibilities.*—Despite all of the statutory and judicial rules that have developed to respond to tax avoidance possibilities created by the *General Utilities* doctrine, there may still be opportunities to achieve a corporate level step-up in basis in an acquisition without a corresponding tax either at the corporate or shareholder level. Obviously, such opportunities may result in significant revenue loss and enhance disrespect for the tax system.

For example, assume that P corporation is interested in acquiring all of the stock of T corporation. T owns principally portfolio stock in corporation A, which is highly appreciated in value, and portfolio stock in corporation B, which is highly depreciated in value. Rather than acquiring T directly, P forms two "mirror" corporations, AA and BB, as wholly-owned subsidiaries, and capitalizes each to reflect the relative values of the A and B stock owned by T. AA and BB then together acquire all of the stock of T. (If the appreciation in A and depreciation in B are about the same, T shareholders may realize little or no gain or loss in that transaction). T then liquidates, distributing the A stock to AA and the B stock to BB. (If the corporations file a consolidated return, this may not result in any recognition of gain or loss to any of the parties.)

If P sells its stock of AA, it may realize little gain or loss on the sale. The purchaser of the AA stock may be able to make a section 338 election, resulting in a stepped-up basis for the A stock held by AA without any corporate level tax. In the meantime, BB may be able to recognize a loss upon the sale of B stock.

To the extent transactions of this sort present tax planning opportunities under current law, they result directly from the continued existence of the *General Utilities* doctrine in a liquidating setting.

### *3. Problems relating to treatment of investors in a reorganization*

In addition to the problems identified above, current law provides some special problems relating to the proper tax treatment of investors in a reorganization.

*a. Treatment of securities.*—Curent law treats the fair market value of securities received in a reorganization as boot except to the extent the principal amount of securities received does not exceed the principal amount of securities surrendered. With the extension of the original issue discount provisions to securities issued in a reorganization, the proper measure of boot is the excess of the issue price of securities received over the basis of securities surrendered.

*b. Treatment of creditors.*—Under current law, boot received by a target corporation in a C reorganization that is distributed to creditors results in the recognition of gain to the target.[131] A more coherent rule would produce the same result whether the target's liabilities are paid by the acquiring corporation, or by the target corporation or its shareholders with funds provided by the acquiring corporation.

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[130] *Compare FEC Liquidating Co.* v. *United States*, 548 F. 2d 924 (Ct. Cls. 1977) *with General Housewares Corp.* v. *United States*, 615 F.2d 1056 (5th Cir. 1980).

*c. Treatment of boot received by shareholders.*—Under present law, it is unclear when a distribution of boot to shareholders in a reorganization has the effect of a dividend. Case law is split on the question.[132] It is also unclear whether a shareholder's ratable share of earnings and profits includes the earnings and profits of the acquiring corporation, the target corporation, or both.

Even where a distribution of boot is properly characterized as a dividend to a shareholder, present law limits the amount of the dividend to the amount of the gain recognized by the shareholder in the transaction. This is a curious mixing of dividend and sale or exchange concepts. This limitation permits shareholders with a high basis in their stock, typically where they have recently purchased or inherited the stock, to withdraw corporate earnings in a reorganization without dividend consequences. This result could not be accomplished apart from a reorganization.

*d. Treatment of controlling corporate shareholders.*—Under present law, a single economic loss may be reflected in both a controlling corporate shareholder's basis in the stock of a target corporation, and the target's basis in its assets. In each case, basis may exceed fair market value.

In an acquisition of the target that qualifies as a reorganization, the economic loss inside the target is preserved through the mechanism of carryover basis. The controlling corporate shareholder's built-in loss in the target stock, however, is also preserved if the controlling corporate shareholder receives stock of the acquiring corporation in the transaction. This may inappropriately result in planning opportunities to generate multiple corporate-level losses that reflect only a single economic loss.

### *4. Discontinuities between stock and asset acquisitions*

An acquisition of the stock of a target corporation and an acquisition of its assets often have identical economic consequences. Under present law, however, the tax consequences of the two transactions may vary dramatically.

*a. Acquisition of stock v. acquisition of assets.*—An acquisition of stock may be taxable or tax-free to the target shareholders, depending upon whether the transaction qualifies as a reorganization. In either event, there is no immediate corporate level tax consequences in the transaction, no step-up in the basis of the corporate assets, and absent some limitation under section 382, corporate level attributes are preserved intact. An exception applies where the transaction is taxable at the shareholder level and a section 338 election is made.

In contrast, an asset acquisition triggers immediate tax consequences at the corporate level unless the transactions qualifies as a reorganization. If the transaction is not a reorganization, the acquiring corporation obtains a stepped-up basis in assets acquired, and corporate attributes are terminated. The target corporation may or may not recognize gain in the transaction. Shareholder level gain may be capital gain or treated as a dividend.

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[131] *Minnesota Tea* v. *Helvering*, 302 U.S. 609 (1938).

[132] *Compare Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973) *with Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978).

In short, current law permits taxpayers to structure economically equivalent transactions in a variety of ways, sometimes with dramatically disparate tax consequences. This flexibility operates to the benefit of the well-advised, but to the detriment of the ill-advised. No policy justification can be found for this outcome.

*b. Basis in stock in controlled subsidiaries.*—The discontinuities under current law between stock acquisitions and asset acquisitions often result from the disparities between "outside" stock basis and "inside" asset basis of a controlled subsidiary. Yet, current law does not provide any uniform system for conforming the two.

For example, if P acquires the stock of T in a B reorganization, P's basis in the T stock is determined by the historical basis of the former shareholders of T in their stock. This may present significant practical problems. Further, the historical stock basis of the former shareholders may have no relation to the "inside" asset basis of T.

If, on the other hand, P acquires the assets of T and then drops the assets down to newly-formed S, P obtains a basis in S stock equal to the net basis of the T assets. This is to be contrasted with a transaction where P forms S first (with P stock) and then S acquires the T assets directly (for the P stock). In that case, P may have a zero basis in its stock of S.[133]

Where P and S do not file a consolidated return, S's net inside basis will gradually be increased to reflect S's earnings. No adjustment is mandated for P's basis in the S stock.

Where P and S do file consolidated returns, P's basis in S is generally increased by the amount of S's earnings and profits. But S's earnings and profits and its taxable income may differ dramatically, creating different basis adjustments to the S assets and the stock in S.

### *5. Problems relating to transfers to controlled subsidiaries*

*a. Overlap.*—As noted, it is possible to structure an acquisitive transaction under section 351. Where the tax consequences of a "reorganization," as compared to a section 351 transfer, are different, discontinuities arise.

*b. Treatment of securities.*—One example of the disparate consequences between a reorganization and a section 351 transaction is in the treatment of securities received by the transferor. Under section 351, securities are received tax-free without limitation. In a reorganization, securities are received tax-free, but only to the extent the principal amount of securities received does not exceed the principal amount of securities surrendered.

*c. Treatment of other debt instruments.*—Debt instruments not qualifying as securities are taxable as boot to the transferor in a section 351 transaction. Where the instrument qualifies for installment sale treatment, however, gain to the transferor may be deferred. At the same time, taxpayers may claim that the transferee is entitled to an immediate step-up in basis. It also may be possible to achieve the same result with a security by transferring the property to the controlled subsidiary in an installment sale transaction outside of section 351.[134]

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[133] Prop. reg. sec. 1.358-6 (January 2, 1981) would conform P's basis in the S stock in this case to the dropdown case.

*d. Assumption of liabilities.*—Under present law, if a corporation transfers property to a controlled subsidiary in a section 351 transaction in exchange for stock and cash, the cash is treated as boot to the transferor. In contrast, if immediately prior to the section 351 transaction, a corporation incurs a liability, retains the cash proceeds, and has its subsidiary assume the liability in the section 351 transfer, the transferor may not have any boot in the transaction. The tax avoidance limitation of present law is, at best, a weak deterrent. No policy justification can be found for maintaining this discontinuity.

*e. Basis rules.*—In a section 351 transfer, the transferor obtains a basis in the stock of the controlled subsidiary equal to the basis of the property transferred in the transaction. Where the property transferred has a built-in loss (*i.e.*, basis in excess of fair market value), this rule may permit the selective duplication of corporate level losses.

### *6. Differing definitions of "Control"*

The definition of an affiliated group involves 80 percent ownership of both voting power and value of another corporation's stock. In contrast, the definition of "control" applicable to reorganizations, section 351, section 332, and section 338 do not involve the element of value. Furthermore, certain preferred stock is counted in the reorganization definition of control and for purposes of section 351, but not for the other provisions.

These discontinuities in definitions may lead to unintended and inappropriate results For example, assume that P and S comprise an affiliated group, but that P's ownership of S stock does not satisfy the ownership requirements of section 332. A liquidating sale by S may qualify under section 337 because the liquidation of S is not a section 332 liquidation (section 337(c)(2)). That result is appropriate, however, only if P recognizes gain on the liquidation of S. If P and S file a consolidated return, S's liquidation may not be taxable to P under Treas. Reg. section 1.1502-14(b) (assuming S distributes no cash to P in the liquidation). Thus, S could dispose of all of its assets and liquidate, with neither P nor S incurring any tax liability.[135]

### *7. Problems relating to net operating loss carryover rules*

Both current law and the 1976 Act amendments suffer from the basic, conceptual difficulty that the rules operate to limit the amount of the loss carryover and do not focus upon the ability (or inability) of the loss corporation to use its losses. Thus, in a case where the amount of loss carryovers far outweigh the other elements of value of the target corporation, [illegible]ent law and the 1976 Act amendments may present little or no barrier to a purely tax-motivated transaction. On the other hand, the rules may disallow all or a part of a loss carryover even where the carryover has minimal economic significance in the transaction. From a policy standpoint, if there are to be any rules limiting the carryover of net operating losses in an acquisition, they should presumably operate most harshly in the case of purely tax-motivated transactions, and least harshly where the transaction is fundamentally an economic one.

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[134] *See Warren Brown* v. *Commissioner*, 27 T.C. 27 (1956).

[135] S. 814, the Technical Corrections Act of 1985 recently introduced by Senators Packwood and Long, would remedy this problem.

Aside from this fundamental problem, there are a number of technical problems with current law.

*a. Continuity of business requirement.*—Under section 382(a), continuation of a business of the loss corporation preserves its net operating losses. Aside from definitional issues, this rule applies even where the continued business is a relatively insignificant part of the surviving corporate enterprise, and where it produces little or no income against which the loss carryovers are utilized. Furthermore, the requirement provides an incentive to continue a business which has proven to be an uneconomic enterprise.

*b. Cliff effect.*—Current section 382(a) either allows loss carryovers to be preserved intact, or completely eliminates them. This may produce overly harsh or overly generous results in certain circumstances.

*c. 20 percent threshold.*—By fully preserving loss carryovers where there is a mere 20 percent continuity of interest in a reorganization, current section 382(b) permits unlimited carryovers even where there has been a significant change in control of the loss corporation. The 40 percent threshold under the 1976 Act amendments still permits unlimited carryovers in a change in control transaction.

*d. Inconsistent rules.*—By providing different tests and differing tax consequences in "purchase" and "reorganization" transactions, current section 382(a) and (b) do not operate harmoniously. There is no policy reason to continue this.

*e. Built-in losses.*—Neither current law nor the 1976 rules adequately addresses the question of built-in losses (*i.e.*, losses that have accrued economically but have not yet been realized). Any rules limiting the availability of net operating loss carryovers after an acquisition should provide consistent treatment to built-in losses.

*f. Rules not comprehensive.*—A change in control resulting from the issuance of new stock does not constitute a purchase under current law and therefore avoids the section 382 limitations. Certain subsidiary acquisitions and B reorganizations may also be outside any limitation. Further, under current law, it may be possible to circumvent the rules for determining whether a change in ownership has occurred by issuing certain voting preferred stock in the transaction.

*g. Complexity.*—Both current law and, in particular, the 1976 Act amendments, have been criticized as excessively complex.

*h. Uncertainty.*—The continued viability of the *Libson Shops* doctrine under current law is unclear. Similarly, section 269 necessarily overlays an element of uncertainty into any acquisition where a carryover is present.

*i. Consolidated return regulations.*—Despite additional limitations imposed by the consolidated return regulations, it may be possible to circumvent the rules by transferring profitable businesses or assets to the loss corporation after its acquisition.

### *8. Problems relating to interaction between subchapter C and subchapter S*

Under current law, a C corporation that elects S corporation status may be able to avoid a corporate level tax on the appreciation in value of its assets during the period it was a C corporation. This is inconsistent with our corporate tax system. Present law imposes a corporate level tax on certain gains realized within 3 years of an S election. However, that provision does not comprehensively include all accrued gains of a C corporation as of the time of the S election.

In addition, because S corporation status can be affirmatively broken by the corporation, current law does not preclude a corporation from changing from C status to S status, and then back to C status. Hence, it may be possible for a C corporation that desires to remain a C corporation to elect S status for a short period, solely for the purpose of avoiding corporate level tax on gains realized during that period.

It may be appropriate, as a policy matter, to permit certain small, closely-held corporations to avoid paying the corporate level tax on certain C corporation gains. However, if that tax preference is to be bestowed upon only certain corporations and not others, it is preferable to distinguish between and among small corporations on the basis of economic size, rather than some other factor, such as the number of shareholders of the corporation or whether the corporation has only one class of stock.

### *9. Miscellaneous other problems*

*a. Investment company reorganizations.*—Present law generally precludes a tax-free diversification of interests in a reorganization transaction. This is consonant with the policy goal of section 1031, which does not extend tax-free status to exchanges of stock, securities, and similar investments.

Present law is deficient, however, in that the consequences of failing the special investment company provisions is a fully taxable transaction at both the corporate and shareholder levels. The section 1031 policy can be effectively implemented by making any limitation applicable only at the shareholder level.

Present law is also deficient in that it does not comprehensively apply to all potential transactions resulting in diversification of shareholder interests. For example, under present law, if a non-investment company is acquired by an investment company, the special limitations may not apply.

*b. Section 1032.*—Under current law, a corporation recognizes no gain or loss on the receipt of property in exchange for its stock. That rule may not apply if the corporation receiving the property transferred stock of its parent in lieu of its own stock. The same treatment should be provided whether an acquisition is accomplished by the parent corporation or through use of the subsidiary corporation.

*c. Section 333.*—Present section 333 contains certain limitations of questionable policy justification. If the *General Utilities* doctrine is repealed, section 333 can be streamlined and simplified to mitigate the effects of the repeal.

## IV. SUMMARY OF PROPOSALS

The principal proposals contained in the bill are described below. A more detailed description of the proposals is set forth in the Technical Explanation accompanying the bill.

### *A. Definition of qualified acquisition (new section 364 of the Code)*

In general, the bill consolidates, simplifies, and makes uniform the rules classifying corporate mergers and acquisitions, whether treated under current law as a "reorganization", a liquidating sale under section 337 of the Code, or a section 338 stock acquisition.

New section 364 defines "qualified acquisition" as meaning any "qualified stock acquisition" or any "qualified asset acquisition." A qualified stock acquisition is defined as any transaction or series of transactions during the 12-month acquisition period in which one corporation acquires stock representing control of another corporation. A qualified asset acquisition means (1) any statutory merger or consolidation, or (2) any other transaction in which one corporation acquires at least 70 percent of the gross fair market value and at least 90 percent of the net fair market value of the assets of another corporation held immediately before the acquisition, and the transferor corporation distributes, within 12 months of the acquisition date, all of its assets (other than assets retained to meet claims) to its shareholders or creditors.

For these purposes, the definition of "control" is conformed to that contained in section 1504(a)(2) of the Code.

Where an acquiring corporation makes a qualified stock acquisition of a target corporation and the target corporation owns stock in a subsidiary, a special rule would treat the acquiring corporation as having also acquired the stock of the subsidiary, for purposes of determining whether the acquiring corporation has made a qualified stock acquisition of the subsidiary.

A special rule is also provided where an acquisition might qualify as both a qualified asset acquisition and a qualified stock acquisition. For example, where an acquiring corporation acquires all of the assets of a target corporation, and certain of those assets consist of all of the stock of a subsidiary, the transaction is treated as a qualified stock acquisition of the subsidiary and a qualified asset acquisition of all of the other assets of the target corporation.

The common-law doctrines of continuity of interest, continuity of business enterprise, and business purpose would have no applicability in determining whether a transaction qualifies as a qualified acquisition.

The bill repeals section 368. Acquisitive reorganizations ("A", "B" and "C" reorganizations and subsidiary mergers) under current law would be replaced by the rules for qualified acquisitions. The "D" reorganization rules would be replaced by special rules (described below) relating to qualified acquisitions between related parties. Transactions qualifying under current law as an "E" reorganization (a recapitalization) and an "F" reorganization (a mere change in identity, form, or place of organization of one corporation) are conformed to the definition of qualified acquisitions. Finally, the "G" reorganization rules (bankruptcy reorganizations), developed largely in response to continuity of interest problems in those types of transactions, are no longer needed and therefore are repealed.

### *B. Elective tax treatment of qualified acquisitions (new section 365 of the Code)*

The corporate level tax consequences of a qualified acquisition are explicitly made elective. Under new section 365, all qualified acquisitions are treated as "carryover basis acquisitions" unless an election to be treated as a "cost basis acquisition" is made.

In general, elections may be made on a corporation-by-corporation basis. Thus, for example, if an acquiring corporation makes a qualified stock acquisition of both a target corporation and a target subsidiary, a cost basis election may be made for the target corporation but, if desired, no such election need be made for the target subsidiary.

Within a single corporation, the same election must generally apply for all of the assets of the corporation. A consistency rule would provide that assets that are acquired which were held by a single corporation during the consistency period must be treated consistently, either as all cost basis or all carryover basis.

Notwithstanding the consistency rule, an inconsistent carryover basis election may be made with respect to goodwill and certain other unamortizable intangibles. For example, a separate carryover basis election may be made with respect to such property even though a cost basis election is made for all of the other assets of the target corporation.

In general, no cost basis election may be made with respect to any qualified acquisition between related parties. These generally refer to transactions where, after application of the attribution rules, there is 50 percent or greater common ownership between the target and acquiring corporations. In addition, no cost basis election may be made with respect to a transaction qualifying as an "E" or "F" reorganization under current law. Finally, a mandatory cost basis election generally applies to a qualified asset acquisition where the acquiring corporation is a non-taxable entity (such as a tax-exempt entity, a regulated investment company, or a foreign corporation).

An election must be made before the later of (1) the 15th day of the 9th month following the month in which the acquisition date occurs, or (2) the date prescribed in regulations. Once made, an election is irrevocable.

### *C. Corporate level tax consequences of qualified acquisitions (sections 361, 362 and 381 of the Code)*

The corporate level tax consequences of a qualified acquisition result directly from the election made at the corporate level. For example, in the case of a carryover basis acquisition, no gain or loss is recognized by the target corporation and the acquiring corporation obtains a carryover basis in any assets acquired. Attributes carry over under section 381.

In the case of a cost basis acquisition, the target corporation recognizes gain or loss and the acquiring corporation obtains a basis in any assets acquired determined under section 1012. Attributes do not carry over. Where the cost basis acquisition is a qualified stock acquisition, the target corporation is deemed to have sold all of its assets for fair market value at the close of the acquisition date in a transaction in which gain or loss is recognized, and then is treated as a new corporation which purchased all of such assets as of the beginning of the day after the acquisition date.

A special rule is provided in the case where a target corporation is a member of an affiliated group and a cost basis election is made. In general, unless the parties elect otherwise, a target corporation in that situation shall not be treated as a member of such group with respect to the gain or loss recognized in the transaction.

The basis of any property received by a target corporation in a qualified asset acquisition is the fair market value of such property on the acquisition date. The basis of stock acquired by an acquiring corporation in a qualified stock acquisition is determined under new section 1020 of the Code (see description below for rules concerning basis of stock of controlled subsidiaries).

Under the bill, sections 337 and 338 of current law are repealed.

### *D. Shareholder level tax consequences of qualified acquisitions (sections 354, 356, and 358 of the Code)*

In general, shareholder level tax consequences of a qualified acquisition are determined independent of the corporate level tax consequences and independent of the election made at the corporate level. Thus, even if a transaction is treated as a cost basis acquisition at the corporate level, it may be wholly or partly taxfree at the shareholder level. In addition, shareholder level consequences are generally determined shareholder-by-shareholder, and the consequences to one shareholder do not affect the tax treatment of other shareholders or investors of the target corporation.

As a general rule, nonrecognition treatment is provided to shareholders or security holders of the target corporation upon receipt of "qualifying consideration," *i.e.*, stock or securities of the acquiring corporation and, where the acquiring corporation is a member of an affiliated group, of the common parent of such group and any other member of such group specified in regulations. The nonrecognition rule applies to the receipt of securities only to the extent the issue price of any securities received does not exceed the adjusted basis of any securities surrendered.

A special rule is provided in the case of investment company stock. In general, stock or securities of an investment company does not qualify as qualifying consideration. An exception applies, however, and such stock or securities will qualify as qualifying consideration, if the target corporation is a diversified investment company. The term "investment company" and "diversified investment company" generally have the same meaning as under current law. In short, the existence of an investment company as the acquiring corporation may affect the tax treatment of the transaction at the shareholder level, but does not affect the corporate level tax consequences.

Receipt of "nonqualifying consideration" (*i.e.*, any consideration other than qualifying consideration) generally results in recognition of gain to the shareholder or security holder. Such gain is treated as gain from the sale or exchange of property unless the receipt of nonqualifying consideration has the effect of a distribution of a dividend. The determination of dividend effect is made by treating the shareholder as having received only qualifying consideration in the exchange, and then as being redeemed of all or a portion of such qualifying consideration (to the extent of the nonqualifying consideration received). For these purposes, earnings and profits of both the target and acquiring corporations are generally taken into account.

Special rules are provided where there is a controlling corporate shareholder of the target corporation. In general, these rules are designed to avoid a second corporate level tax where the target corporation is acquired in a cost basis acquisition. In addition, where the target corporation is acquired in a carryover basis acquisition and all or part of the consideration is nonqualifying consideration, these rules are designed to insure that the controlling corporate shareholder or a distributee of such shareholder will recognize gain on the receipt of the nonqualifying consideration.

In general, shareholders or security holders obtain a substitute basis in any nonqualifying consideration received, and a fair market value basis in any nonqualifying consideration received. Controlling corporate shareholders of the target corporation generally obtain a basis in any qualifying consideration received equal to the lesser of substitute basis or fair market value basis.

### *E. Tax consequences of distributions*

#### *1. Corporate level tax consequences (section 311 of the Code)*

Under the bill, a corporation generally recognizes gain on the distribution of property with respect to its stock, regardless of whether the distribution is liquidating or nonliquidating. In the case of a liquidating distribution, loss is also recognized. Gain or loss is determined in the same manner as if the property distributed had been sold to the distributee at its fair market value.

Exceptions to the general rule are provided in the case of (1) distributions where the distributee's basis is determined under section 334(b) of current law; (2) distributions qualifying as a section 355 transaction; and (3) distributions of stock of a 5-year-or-greater controlled subsidiary of the distributing corporation.

Under the bill, sections 336 and 341 of current law are repealed.

#### *2. Shareholder level tax consequences (sections 331, 332, 333, 334, 354, 356, and new section 1060 of the Code)*

The bill generally retains section 331 of the Code, which provides for the recognition of gain or loss by a shareholder on the receipt of property in a liquidation, with the shareholder obtaining a fair market value basis in the property distributed. The bill also generally retains section 332 of the Code, which provides nonrecognition treatment to a corporation upon liquidation of its controlled subsidiary. (The bill conforms the definition of control for purposes of section 332 to the meaning contained in section 1504(a)(2).) As under current law, in a section 332 liquidation, the corporate shareholder obtains a carryover basis in the property distributed.

The bill permits a shareholder to avoid gain recognition in a liquidation if the shareholder agrees to take a substitute basis in the property distributed. Under simplified new section 333, at the election of the shareholder, gain shall be recognized only to the extent of the money, stock, securities, or similar items received by the shareholder in the liquidation. The one-month rule, dividend treatment, and earnings and profits limitation contained in present section 333 are repealed.

Finally, new section 1060 provides additional shareholder relief in the case of certain qualified acquisitions, in-kind liquidations, and liquidating sales. In general, for purposes of sections 331, 354, and 356, certain shareholders of small corporations would be entitled to increase the basis of their stock in the corporation to reflect the corporate level gain incurred in the transaction with respect to capital assets with a holding period of 5 years or more. Eligible shareholders would include those holding stock in the corporation at the time of the acquisition or liquidation for at least six months, or certain prior holders during the six-month period.

A small corporation would generally be defined as a corporation with a fair market value of $1 million or less. However, relief would also be provided, in decreasing amounts, for corporations up to $2 million in value.

### *F. Basis in stock of controlled subsidiary (new section 1020 of the Code)*

Under new section 1020, the basis of a controlling corporate shareholder in the stock of a controlled subsidiary is generally equal to the net inside basis of the assets of the subsidiary, *i.e.*, the aggregate basis of the assets of the subsidiary reduced by the aggregate adjusted issue prices of the liabilities of the subsidiary. By setting the basis of the stock of the subsidiary generally equal to the basis of the assets of the subsidiary, many of the discontinuities under current law between transactions involving the assets of a subsidiary and transactions involving the stock of such subsidiary are eliminated. Moreover, complex, continuing adjustments to the stock basis, such as those contained in the consolidated return regulations,[136] are not required.

For a three-year period, the net inside basis of the controlled subsidiary must be increased by any balance in a "premium account" or decreased by any balance in a "discount account." The purpose of these adjustments is to avoid the problem of disappearing or excessive basis.

The premium (or discount) account is initially the amount by which the controlling corporate shareholder's basis in the stock of the controlled subsidiary (determined without regard to section 1020) exceeds (or is less than) the net inside basis of the subsidiary. Thus, for example, if a corporation acquires all of the stock of another corporation for $100 and the net inside basis of the assets of such corporation at the time of the acquisition is $80, then there is an initial premium account of $20. Should the corporation, the next day, sell all of the stock of the subsidiary for $100, its basis in such stock would be the net inside basis of the assets of the subsidiary ($80) plus the premium account ($20), or a total basis of $100. Accordingly, the corporation would realize and recognize no gain or loss on such subsequent disposition.

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[136] *See* Treas. Reg. sec. 1.1502-32.

Special rules are provided to adjust the accounts for recognized gains and losses of the subsidiary during the three-year period that the accounts are to be maintained. In general, these rules are made necessary to eliminate the problem under current law of permitting double gains or double losses upon the sale of the stock and assets of the subsidiary.

As noted, after three years, the accounts would automatically be zero and no further adjustments would need to be made to them.

### *G. Net operating loss carryovers (new sections 382, 382A, and 383 of the Code)*

The bill proposes a single rule limiting the availability of net operating loss carryovers and other carryforwards after there has been a substantial change in ownership of a corporation. This rule would supercede and replace both the 1954 and 1976 versions of sections 382 and 383, which would be repealed.

Under the general rule, the use by a corporation each year of net operating loss carryovers and other carryforwards after there has been a substantial change in ownership of such corporation would generally be limited to an amount equal to the Federal long-term rate under section 1274(d) times the value of the corporation at the time of the change. For these purposes, a substantial change in ownership would mean any change—whether effected by purchase, merger, asset acquistion, redemption, issuance of new stock, recapitalization, etc., or any combination of the foregoing—resulting in a shift in ownership of the equity of the corporation of more than 50 percent. In making that determination, transactions occurring within a three-year period prior to the change in ownership would be taken into account.

Special rules would be provided so that shifts in ownership as a result of transactions involving shareholders holding less than 5 percent of the stock would be disregarded. In addition, transactions involving commonly controlled or related parties would generally be exempt. Finally, changes of ownership resulting from a work-out of marital difficulties, gifts, bequests, and similar types of transfers would generally be ignored.

Special rules would also be provided in the case of successive ownership changes of the same loss corporation. These rules are designed to preclude the ability to increase the applicable limitation on the use of net operating loss carryovers by entering into successive change transactions. In addition, these rules resolve overlap questions if the limitations arising from the successive changes are not the same.

The bill contains several anti-abuse rules. First, in order to prevent historic shareholders of the loss corporation from trying to increase the value of the loss corporation, or trying to avoid the built-in loss limitations (described below), by means of a capital contribution just prior to a change in control (thereby, for example, increasing the post-change limitation on the use of carryforwards), any capital contribution made as part of a plan the principal purpose of which is to avoid any limitation under section 382 would be disregarded. Generally, contributions made within two years of the change would presumptively be considered part of such plan, subject to rebuttal by the taxpayer.

Second, no carryforwards would survive if two-thirds or more of the loss corporation's assets at the time of the change in control are assets held for investment. Assets held for investment would generally not include assets used in an active trade or business, whether or not the business is actively conducted at the time of the change of control. This rule would preclude the trafficking of carryforwards in largely shell corporations.

Finally, special rules are provided in the case of certain built-in gains and losses (*i.e.*, gains and losses that have economically accrued at the time of the change in control, but have not yet been realized). Losses attributable to the recognition of built-in losses would generally be subject to the same limitations as net operating loss carryforwards. In contrast, any available net operating loss carryovers (or losses attributable to built-in losses) could be used, without limitation, to offset income attributable to the recognition of built-in gains after the change in control. The built-in gain and loss rules would only apply if the aggregate fair market value of the assets of the corporation exceeded 125 percent of the aggregate basis of such assets at the time of the change in control, or was less than 75 percent of such aggregate basis.

The bill also provides a special rule in the case of loss corporations that are under the jurisdiction of a court in a Title 11 or similar case immediately before the ownership change. In general, losses of such corporations would not be subject to limitation under section 382 if the shareholders and creditors of the corporation retain control of the corporation after the change. The determination of the amount of any net operating loss deduction of the corporation after the change, however, would be made after disallowing any interest deductions claimed during the three years preceding the change that relate to indebtedness which is converted into stock in the change. (This rule acknowledges that the creditor interest before the change was, in reality, an equity interest, and therefore, amounts payable to the holder of the interest would not be deductible by the corporation.)

Furthermore, no carryovers would survive a second ownership change of the same loss corporation within two years of any change that is subject to the special Title 11 rule. Because the value of the corporation at the time of the Title 11 change was presumably zero, and any capital contributions during the ensuing two years are disregarded, this rule explicitly provides that the section 382 limitation at the time of the second change would be zero.

Section 383 would provide similar rules to limit the use of excess credit carryovers, capital loss carryovers, and foreign tax credit carryovers after a substantial change in ownership. Section 269 and the *Libson Shops* doctrine would not apply to disallow carryovers that are limited by new section 382 or 383. The Secretary would be directed to consider what changes, if any, would be necessary and appropriate to the consolidated return regulations in view of the modification to sections 382, 382A, 383, and 269.

### *H. Other principal changes*

#### *1. Section 351*

The treatment of securities received by a transferor in a section 351 transaction is conformed to the treatment under sections 354 and 356 of current law (as modified by this bill). In addition, the term "control" for purposes of section 351 is conformed to the meaning contained in section 1504(a)(2).

The transferor in a section 351 transaction would generally obtain a basis in any qualifying consideration received equal to the lesser of substitute basis or fair market value of the property transferred.

Under the bill, except as otherwise provided in regulations, a transaction qualifying as both a section 351 exchange and a qualified acquisition would be treated as a qualified acquisition.

#### *2. Section 357*

Under the bill, the applicability of section 357 is limited to liabilities that are either (1) purchase money indebtedness or (2) assumed or acquired by the transferee incident to the transferee's acquisition, holding, or operation of the property transferred in the ordinary course of business. The bill repeals the tax avoidance exception under current law.

#### *3. Section 1032*

Under the bill, section 1032 is amended to provide that no gain or loss is recognized by a corporation on the receipt of property in exchange for stock of such corporation or of a corporation owning (directly or by attribution) stock representing control of the issuing corporation.

#### *4. Section 1248 and new section 1257*

Two special "shareholder flavoring" rules would be provided under the bill. First, for a three-year period following the contribution of property to a corporation or the development of property by the corporation, gain on the disposition of such property would be treated as ordinary income (section 1257). This rule would apply to both (1) property contributed to the corporation, the gain on which would be ordinary income to the contributing shareholder, and (2) property developed or otherwise acquired by the corporation, the gain on which would be treated as ordinary income to shareholders holding a substantial portion of the stock of the corporation.

Second, a similar rule would apply in a section 1248 transaction if 70 percent or more of the assets of a foreign corporation would be ordinary income property in the hands of certain shareholders of the corporation.

### 5. *Amendments to S Corporation provisions (sections 1367 and 1368)*

Under the bill, in the case of a C corporation which makes an election to be an S corporation, a shareholder's basis in the stock of the corporation would not be increased for a portion of the gain recognized by the corporation within 5 years of the election. The rule would not apply to gain from the sale or exchange of capital assets with a holding period of 5 years or more, or to gain allocable to periods during which the corporation was an S corporation. The same result would apply where, in a qualified asset acquisition, the target corporation is a C corporation, the acquiring corporation is an S corporation, and no cost basis election is made. Gain that does not increase stock basis would increase the accumulated adjustments accounts five years after the election or acquisition.

The above rules would not apply if the S corporation has a fair market value of $1 million or less. The above rules would apply, but with reduced impact, for S corporations with a fair market value of $2 million or less.

Under the bill, section 1374 of current law would not apply to any gain subject to the new rules.

## V. GENERAL COMMENTS

### *A. Proposals relating to acquisitions*

As noted, the major proposals in the acquisitions area set forth in the September, 1983 Staff Report were very favorably received at the October, 1983 hearing.[137] Accordingly, the bill has adhered closely to those proposals, which were based in large part upon the American Law Institute recommendations. The bill simplifies and makes uniform the rules classifying corporate mergers and acquisitions, provides for explicit elective tax treatment of the transaction at the corporate level, separates the corporate level tax consequences from the shareholder level tax consequences, and permits shareholder consequences to be determined independent of the tax consequences to other shareholders or investors. The bill has also implemented many of the other specific acquisitions proposals contained in the Staff Report, thereby resolving a number of inconsistencies under current law and removing much complexity and uncertainty.

In an attempt to facilitate the transition between existing law and the new proposals, the bill retains as much of current law as possible, including the use of the same Code sections. In addition, in order to minimize the degree and period of uncertainty that necessarily follows from a significant modification to any area of law, the bill has kept the delegation of regulatory authority to a minimum and, wherever possible, has provided that the regulatory flexibility will operate as an exception to the statutory rule, rather than as an implementation of the statutory rule. It is also expected that extensive explanatory materials similar to the General and Technical Explanations accompanying this bill will be provided with any enacted legislation.

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[137] *See* footnote 12, *supra*.

### *B. Repeal of General Utilities doctrine*

Although the response with respect to the major acquisitions proposals was very favorable, the reaction of those who testified regarding the proposed repeal of the doctrine originating with the Supreme Court's decision in *General Utilities and Operating Company* v. *Helvering*, 296 U.S. 200 (1935), was much more mixed.[138] That case is often cited for the proposition that a corporation recognizes no gain or loss upon the distribution of appreciated property with respect to its stock. In addition, because of the difficulty in distinguishing between a sale of appreciated property by a corporation and a distribution by the corporation of such property to its shareholders followed by a sale by the shareholders,[139] the doctrine is also often considered as encompassing the rule set forth in section 337 of current law providing for the nonrecognition of gain or loss in certain liquidating sales.

Because of the mixed reaction, some thought was given to proceeding with the acquisition proposals, but without a repeal of *General Utilities.* For reasons described below, that view was quickly rejected, and it was determined that a repeal of *General Utilities* was essential to implementation of the other proposals.[140]

First, the Treasury Department appropriately indicated in its testimony that although it supported the major proposals on acquisitions, its support was contingent upon a complete repeal of the *General Utilities* concept.[141] The Treasury Department stated:

> We strongly believe, however, that corporate level electivity is proper and appropriate *only* if Target is required to recognize its gains and losses in any case where a taxable election is made. Thus, the *General Utilities* doctrine must not be applicable in these cases.[142]

The Treasury Department later expanded upon the reasons for its position:

> Finally, under the proposals, the corporate parties can elect to step-up the basis of the acquired assets even though the Target shareholders are not taxed upon the receipt of acquiring stock. Failure to impose a corporate tax in such circumstances would cause a significant reduction in the tax base with no immediate tax to any of the parties to the transaction.[143]

Treasury's concern can best be illustrated by the following simple example. Assume that P corporation acquires all of the assets of T corporation in exchange for P stock. Under current law, if the transaction qualifies as a "C" reorganization, then the transaction would be tax-free to both T and the T shareholders, but P would obtain the T assets with a carryover basis. In contrast, if the transaction qualifies under section 337, P could obtain a cost basis in the assets acquired but, upon the liquidation of T, the receipt of P stock by the T shareholders would be fully taxable to them.

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[138] *See* footnotes 20-23, *supra*, and accompanying text.

[139] *Compare Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945) *with United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950).

[140] This proposal is, of course, hardly new. *See, e.g.*, Lewis, "A Proposed New Treatment for Corporate Distributions and Sales in Liquidation," House Committee on Ways and Means, 3 Tax Revision Compendium 1643 (1959). In his cogent article, Mr. Lewis proposed repealing the *General Utilities* doctrine on the grounds of simplicity, revenue protection, and equity. It is indicative of how little progress has been made in the area that many of his criticisms—over 25 years old—are still entirely pertinent today. For an excellent recent article analyzing this issue, see Shube, "Corporate Income or Loss on Distributions of Property: An Analysis of *General Utilities*," 12 J. of Corp. Tax. 3 (Spring, 1985).

[141] *See* footnote 21, *supra*.

[142] Pearlman testimony at 19 (emphasis in original).

[143] *Id.*

Under the proposals, if a cost basis election were made and *General Utilities* were not repealed, P could obtain a cost basis in the assets acquired while the transaction would be tax-free to both T (because of the retention of *General Utilities*) and the T shareholders (because of the receipt of qualifying consideration). No one who testified in favor of retaining *General Utilities* gave any indication that the above result was appropriate or desirable.

Some thought was given to developing rules to remedy the above example. However, such rules would have required a significant modification to, if not elimination of, several of the cornerstones to the acquistions proposals, including the explicit corporate level electivity of tax consequences, and the separation of corporate level and shareholder level tax consequences. Given the enthusiasm with which those proposals were received at the hearing, and given the time and effort it had taken the American Law Institute to develop those proposals, it was not considered advisable to try to modify those fundamental recommendations. Thus, the complete repeal of *General Utilities* became imperative if the remaining proposals were to be implemented.

A second reason in favor of the proposed repeal of *General Utilities* was the general concern that, by providing markedly different tax consequences for different types of distributions, current law creates tremendous pressure in favor of certain types of transactions over others. This pressure makes the system non-neutral and subject to manipulation, and adds great complexity to the area. This concern was very ably articulated by John S. Nolan, then-Chairman of the Tax Section, American Bar Association, in his testimony before the Committee opposing certain of the changes that were ultimately enacted in the Tax Equity and Fiscal Responsibility Act of 1982:

> Rational tax policy could either embrace the *General Utilities* principle in full or reject it in full. Rational tax policy cannot, however, embrace it only in part, and much mischief has come from prior attempts to do so.
>
> Thus, when some distributions (e.g. redemptions and partial liquidations) are made taxable at the corporate level while others (e.g., ordinary distributions and complete liquidations) are not, immense tax differentials are created. These differentials result in pressure to avoid the more onerous classifications and to enjoy the more liberal ones. They necessitate much complexity in the tax system. . . . [144]

Obviously, Mr. Nolan's concern could have been addressed by means of a complete retention of the *General Utilities* doctrine rather than a complete repeal of it. But Congress, as early as 1954 when the *General Utilities* principle was codified in sections 311, 336, and 337 of the Code, has enacted a series of exceptions and limitations to the general rule, largely targeted at specific types of transactions that presented possibilities of tax avoidance. For example, in 1954, three statutory exceptions to section 311(a) were enacted as "appropriate safeguards . . . to prevent tax avoidance."[145]

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[144] Hearing on the Tax Treatment of Corporate Mergers and Acquisitions before the Commitee on Finance, United States Senate, 97th Cong., 2d Sess. (July 15, 1982), testimony of John S. Nolan on behalf of the Tax Section of the American Bar Association, HG 97-106 at 111.

In his article, Mr. Lewis made a similar point: "The provisions hardly pay lip service to the 'double tax' system. Congress has sawed off the tailgate of the corporate tax wagon. In so doing, it has weighted the tax system in favor of business liquidators and traders and against continuing owners. The latter are exposed to the double tax; the former (provided they escape the erratic policeman, the 'collapsible corporation' provision) are not." *See* Lewis, "A Proposed New Treatment for Corporate Distributions and Sales In Liquidation," House Committee on Ways and Means, 3 Tax Revision Compendium 1643, 1644-45 (1959).

Further exceptions and limitations were enacted in the Revenue Act of 1962,[146] the Revenue Act of 1964,[147] the Tax Reform Act of 1969,[148] the Tax Reform Act of 1976,[149] the Crude Oil Windfall Profits Tax Act of 1980,[150] the Tax Equity and Fiscal Responsibility Act of 1982,[151] and the Deficit Reduction Act of 1984.[152] Given that history, it seemed extremely unlikely that Congress would reverse itself in all of those areas by eliminating all of those exceptions to the *General Utilities* doctrine, thereby opening up the possibility of certain tax avoidance transactions that Congress had carefully attempted to foreclose.

Moreover, even among those who testified in favor of retaining *General Utilities,* the view was expressed that a further cut-back of the doctrine might be appropriate.[153] The clear direction of Congress and those who testified, therefore, was towards a complete repeal of the doctrine rather than a full retention of the general rule. It seemed clear, then, that total repeal of the doctrine was the only appropriate way to address the concern raised by Mr. Nolan.

A third principal reason favoring repeal was the general view that the lack of symmetry provided by the rule created uncertainty and the potential for manipulation. Under sections 337 and 338 of current law, absent any statutory or common-law exceptions, the "price" to be paid for a corporate level step-up in basis is a shareholder level tax, measured by the difference between the fair market value of the shareholder's stock and his basis in such stock. In many cases, the amount of shareholder level tax has no relationship whatsoever to the amount of the corporate level step-up. The tax may be disproportionately large if the shareholder's stock basis is dramatically lower than the corporation's basis in its assets. Alternatively, the tax may be disproportionately small if the stock basis is much higher than the corporation's asset basis. In many cases, there may not be any shareholder tax because of the operation of section 1014 or the fact that the shareholder is not a taxpaying entity.

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[145] S. Rep. No. 1622, 83d Cong., 2d Sess. 247, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4785, 4884. The three exceptions were section 453(d) (now section 453B) involving installment obligations; section 311(b), relating to LIFO inventory; and section 311(c), concerning property distributed subject to a liability in excess of basis. Congress apparently also intended at that time to retain certain of the judicially-created exceptions to *General Utilities*, such as the assignment of income doctrine. *See*, S. Rep. No. 1622, 83d Cong., 2d Sess. 247, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4785, 4884; Treas. Reg. sec. 1.311-1(a).

[146] Sections 1245 (gain from disposition of depreciable personal property) and 47 (recapture of investment tax credit).

[147] Section 1250 (gain from disposition of depreciable real property).

[148] Section 1252 (gain from disposition of farm land) and 311(d) (certain redemption distributions).

[149] Section 1254 (recapture of certain intangible drilling and development costs).

[150] Section 336(b) (LIFO recapture in complete liquidations).

[151] Section 311(d)(2) (repeal of certain exceptions to section 311(d)(1)).

[152] Section 311(d)(1) (nonliquidating distributions of appreciated property).

[153] *See* footnote 30, *supra. See also* ABA Section of Taxation Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock" (hereinafter "ABA Task Force Report"), 37 Tax Lawyer 625, 631, which recommended further limiting the *General Utilities* concept to exclude all nonliquidating distributions and liquidating distributions of ordinary income assets and certain capital gain assets. The Minority Report did not take issue with the recommendations regarding nonliquidating distributions and liquidating distributions of ordinary income items. 37 Tax Lawyer at 640.

To the well-advised, this lack of symmetry provides an opportunity for considerable manipulation. Essentially, by liquidating or not liquidating the target corporation, the well-advised can secure a step-up in basis at whichever "price"—the corporate level tax or the shareholder level tax, if any—is smaller.[154] Obviously, to the ill-advised, these same rules can operate as a trap, producing a disproportionately large tax liability. No policy reason could be found for continuing this asymmetrical effect which often operates to the detriment of small, closely-held family businesses that are not well-advised. At the October, 1983 hearing, the Treasury Department stated that "(t)he symmetry between basis step-up and gain recognition provided by repealing the *General Utilities* doctrine would significantly improve the system for taxing corporate acquisitions." [155]

A final reason for repeal was the concern that tax avoidance possibilities may still exist as a result of the doctrine. As noted, over the years, a number of limitations and exceptions to the rule have been enacted, generally in response to possible tax avoidance transactions. As described earlier, there may still be opportunities for both a corporation and its shareholders to avoid tax in an acquisition, while permitting a cost basis to be obtained by the acquiring corporation. To the extent these opportunities still exist, they may result in significant revenue loss and enhance disrespect for the tax system. A complete repeal of the *General Utilities* doctrine would foreclose those possibilities.

### *C. Relief from repeal of General Utilities doctrine*

Many people who testified at the October, 1983 hearing advocated some form of relief from the repeal of *General Utilities.*[156] The original proposal contained in the Staff Report suggested the possibility of transitional relief in the form of a phase-in of the corporate capital gains tax over a 10-year period.[157] Several people testified that such relief would be inadequate, and that some permanent relief was essential.[158]

In deciding what type of permanent relief, if any, might be appropriate, two questions had to be resolved: (1) in what type of transactions should relief be provided; and (2) what form should the relief take?

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[154] Where the corporation's basis in its assets is greater than the shareholder's basis in his stock, the taxpayer can pay the small corporate level tax and avoid the large shareholder tax by not liquidating the corporation. It may be possible to continue to operate the corporation as a holding company making investments while avoiding the personal holding company penalty tax. *See* Forbes, "Pocketbook, Incorporated" (January 28, 1985) at 84.

[155] Pearlman testimony at 20. The American Law Institute stated: "But the basic trouble with [the *General Utilities* doctrine], and the generating source of the exceptions and qualifications that make it so complicated, is the liquidation-nonrecognition rule itself. General exemption from corporate tax of gain unrealized prior to a corporate liquidation is simply out of harmony with the treatment of too many other things. It is out of harmony with the treatment of alternative courses of conduct, with the treatment of other parties, and with other aspects of the prior taxation of the liquidating corporation itself."—American Law Institute, *Federal Income Tax Project: Subchapter C,* (1982) at 111.

[156] *See* footnotes 31 and 32, *supra.*

[157] Staff Report at 65–66.

[158] *See, e.g.,* Cohen testimony at 180.

### *1. Eligible transactions*

Almost all who testified in favor of some form of permanent relief confined their remarks to the need for relief in a complete liquidation or liquidating sale. No one testified as to the need for relief in a non-liquidating setting. Indeed, even as to liquidating transactions, most individuals indicated that any permanent relief should be appropriately limited to the potential "double tax" on long-held capital assets.[159]

However, one of the reasons described above in favor of the repeal of *General Utilities* was the concern that current law creates a bias in favor of certain types of transactions over others, providing much complexity and abuse potential. If any *General Utilities* relief were limited as suggested by those who testified, there was the possibility that the same problems as under current law would be revived.

Providing across-the-board relief in all transactions, liquidating and non-liquidating, seemed out of the question because of revenue considerations.[160] It seemed advisable, therefore, that any permanent relief should be targeted as closely as possible to the specific need for the relief.

In the large majority of cases, opposition to the repeal of *General Utilities,* and support for some form of relief, was based upon the concern that a "double tax" on long-held assets of small businesses was too harsh.[161] The view was expressed that a small businessman whose incorporated business holds appreciating capital assets for an extended period of time should not be required to pay both a corporate level and a shareholder level tax upon the liquidation or acquisition of the business. According to this view, this was particularly true because the gains might be largely inflationary.[162] However sympathetic the preceding case might be, the case of a speculator who owns stock of a large publicly-held corporation just prior to the liquidation or acquisition of such corporation appeared clearly less appealing as to the need for "double tax" relief. Thus, it seemed appropriate to consider limiting any relief to long-held gains of small businesses.

Moreover, there was testimony that the impact of the repeal of *General Utilities* (and the consequent need for some form of relief) would fall almost exclusively upon small, closely-held businesses, and that large, publicly-held corporations would rarely be affected.[163] Finally, to the extent the form of the relief (described below) was criticized at the hearing as being too complex, many of those concerns would be eliminated if the relief were limited to a tightly circumscribed number of cases involving smaller corporations.

Accordingly, the bill provides permanent *General Utilities* relief in the case of a small business which incurs gains on long-held assets in a liquidation or liquidating sale. In those circumstances, the "double tax" is effectively eliminated.

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[159] *See* footnote 34, *supra.*

[160] *But see* discussion below regarding the possibility of implementing the Treasury Department's dividends paid deduction proposal. The Treasury proposal, which would provide only partial across-the-board relief, is estimated to cost approximately $85 billion during the first four years that it would be implemented. *See* "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President" (November, 1984) (hereinafter "Treasury Department Tax Reform Proposals"), Vol. 1 at 248.

[161] *See* footnote 24–29, *supra,* and accompanying text.

[162] *See* footnote 24, *supra.*

[163] *See* Nolan testimony at 148, 151.

Five years was chosen as the appropriate dividing line for "long-held" capital assets because, to the extent the proposal is an attempt to mitigate the effects of inflation, it was believed that some significant holding period should be required.[164] Other proposals have suggested three years as the appropriate test.[165]

The $1 million fair market value test for "small" businesses was chosen because of similar standards used in other sections of the Code.[166] In addition, to avoid a cliff effect, the bill proposes to provide relief, in decreasing amounts, for corporations up to $2 million in value.

### *2. Form of the relief*

The two principal forms of relief that were considered were a shareholder credit and corporate-level exemption.[167] Testimony was almost evenly divided between the two types of relief.[168] The American Law Institute had recommended a shareholder credit in its proposal.[169] The special ABA Task Force recommended a corporate-level exemption.[170]

The corporate-level exemption was rejected for the same reasons that a complete repeal of *General Utilities* was considered essential. A corporate-level exemption is no more than a partial repeal of *General Utilities.* Thus, a corporate-level exemption was viewed as presenting many of the same problems that an incomplete repeal of *General Utilities* would have presented.

For example, assume that relief were provided in the form of a corporate-level exemption on capital assets with a holding period of 5 years or more. Assume that P corporation acquires all of the assets of T corporation in exchange for P stock. Further, assume that all of the T assets consist of capital assets with a holding period of 5 years or more.

In this example, a cost basis election could be made, resulting in a cost basis to P in the assets acquired. Because of the exemption, no gain or loss would be recognized by T in the transaction. Finally, in the distribution by T of the P stock, the T shareholders would not recognize any gain or loss because of the receipt of qualifying consideration. In short, the acquisition would result in a cost basis being obtained by the acquiring party without any immediate tax being paid by either the target corporation or its shareholders. No one who testified appeared to advocate this result.

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[164] In that regard, should a proposal such as the Treasury Department's recommendation to index the basis of capital assets for inflation, be enacted, it may be appropriate to rethink the need for the proposed relief. *See* Treasury Department Tax Reform Proposals, Vol. 11 at 178.

[165] ABA Task Force Report, 37 Tax Lawyer 625, 631. The Minority Report did not agree with taxing any capital gains.

[166] *See, e.g.*, section 1244 ($1 million paid-in capital test); *cf.* P.L. 96-223, sec. 403(b), as amended (LIFO recapture amount reduced by $1 million); section 11(b) ($1 million taxable income threshold for graduated rates).

[167] Other relief provided by the bill, including special relief on an in-kind liquidation, is discussed in the next section.

[168] *See* footnotes 31 and 32, *supra.*

[169] American Law Institute, *Federal Income Tax Project: Subchapter C,* (1982) at 134.

[170] ABA Task Force Report, 37 Tax Lawyer 625, 631. The Minority Report did not agree with this recommendation.

Obviously, in most cases, all of T's assets would not consist of capital assets with a holding period of 5 years or more. However, in any transaction, to the extent T's assets did consist of such assets, the potentially inappropriate combination of a cost basis to the acquiring corporation without any immediate tax liability would be available. For many of these reasons, the Treasury Department opposed a corporate-level exemption.[171]

Some consideration was also given to using the S corporation rules as a means to provide the appropriate relief. One individual recommended exploring this option.[172]

The S corporation option was ultimately rejected for two reasons. First, it was clear that many corporations not eligible for S corporation status should, nevertheless, be entitled to relief, so that the S corporation rules would have to be significantly liberalized. While certain of the restrictions under current law defining an S corporation might appropriately be waived or eliminated, at least in the case of a liquidation or liquidating sale, it was unclear that all of the restrictions could be removed. There was concern that to the extent any S corporation limitations remained, some sympathetic cases would be unfairly excluded from relief.

Second, the S corporation relief was also viewed as too generous in certain cases. The S corporation rules do not limit the size of the eligible corporation in economic terms. To the extent relief would be provided only to a limited number of corporations and their shareholders, it was determined that it would be fairer and closer to the targeted goal to draw a distinction based upon economic size rather than upon some other criterion, such as the number of shareholders of the corporation.

Thus, the bill provides for a shareholder credit type of relief from the repeal of *General Utilities*. Each shareholder of a small corporation is provided a basis adjustment in his stock in the liquidating or acquired corporation to reflect the corporate-level tax on long-held capital assets. The basis adjustment approach rather than a shareholder credit was selected to increase administrative simplicity, in order to harmonize the treatment of shareholders in different tax situations and to reconcile the difference between the corporate and shareholder capital gains rates. The basis adjustment would operate to eliminate the "double tax" on long-held capital assets. Only those shareholders holding the stock for six months or more would be entitled to relief.

### *D. Other forms of relief*

In addition to the basis adjustment relief described above, the bill also provides several other forms of relief, including special relief in an in-kind liquidation. As noted, several witnesses recommended some form of special relief in that situation.[173]

Under the bill, any shareholder of a corporation which liquidates in kind is entitled to defer the shareholder level tax with respect to any property distributed to the shareholder in the liquidation, except for cash, stock, securities, and similar property, received. In that respect, the relief is similar to section 333 of current law, except that several of the limitations of that section have been eliminated.

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[171] *See* Pearlman testimony at 22.

[172] *See* Cohen testimony at 173, 177.

[173] See footnote 35, *supra*.

The relief is available to a shareholder of any corporation that liquidates in kind, not just "small" corporations. Shareholders of small corporations would have the option of selecting either the basis adjustment relief described earlier or the deferral of shareholder tax proposal.

Some consideration was given to a deferral of the corporate level tax rather than the shareholder level tax. Ultimately, this was rejected because of the view that the corporate level tax should not be permitted to be deferred beyond the termination of the corporation. Many provisions under current law permit the deferral of corporate tax while assets remain within the corporation or in corporate solution. However, if those benefits represent true "deferrals" rather than an exemption, it seemed appropriate to require the deferral to end upon the liquidation of the corporation, when the assets leave corporate solution.

In addition, the deferral of the shareholder level tax is analogous to the deferral permitted under the bill when a shareholder receives qualifying consideration.

Some thought was also given to a relief proposal in an in-kind liquidation that would permit both the shareholder *and* corporate level taxes to be deferred or avoided. It was noted by several witnesses that a shareholder, who organizes a corporation tax-free under section 351 by mistake and then chooses to liquidate the corporation, should be permitted to defer or avoid both the corporate and shareholder level taxes.[174] This was viewed as particularly appealing in the case where the appreciation in the corporate assets occurred prior to the formation of the corporation—*i.e.,* while the assets were held by the individual shareholder. Under this view, the "disincorporation" transaction should be permitted to be tax-free in the same way that an incorporation transaction is tax-free under section 351.

The potential discontinuity with the treatment under section 351 was a matter of some concern. But ultimately, it was determined that to the extent a discontinuity between incorporation and liquidation transactions exists, it is a problem created by section 351 and not by the proposed rules for an in-kind liquidation.

Section 351 arguably serves the policy goal of facilitating the formation of corporations. More importantly, that policy goal is achievable under section 351 with little or no tax avoidance potential. An individual who forms a corporation with appreciated property is moving that property from a potential "one-tax" system to a potential "two-tax" system. Therefore, permitting that individual to defer tax on the gain that would otherwise be recognized in the incorporation transaction will almost assuredly be a true deferral and not an exemption; indeed, the pre-incorporation appreciation may be taxed twice, not once, as a result of the act of incorporation.

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[174] *See, e.g.,* Maletta testimony at 191-92. A similar point was raised in a letter to Senator Dole dated August 16, 1983 from Harold Handler on behalf of the Committee on Taxation, The Association of the Bar of the City of New York.

The same cannot be said for a liquidation in kind. Arguably, it might be appropriate from a policy standpoint to facilitate certain "disincorporation" transactions by providing tax-free or tax-deferred treatment similar to section 351. But any such relief would be fraught with tax avoidance possibilities. Here, in contrast to section 351, the assets are moving from a potential "two-tax" system to, at most, a potential "one-tax" system. Thus, any "deferrals" permitted at the time of the liquidation may well result in complete exemptions. Possibilities of that sort might well necessitate certain of the complex anti-tax avoidance provisions of current law that are proposed to be eliminated by the bill.

Finally, a proposal to defer or exempt both the shareholder and corporate level taxes raised a number of unresolved issues with no clear policy direction. For example, should any such relief be limited to a short-term "mistake" case described above, or should it be available only where the shareholders have held the stock for some extended period of time, as was suggested by one witness?[175] Should the relief be limited to built-in gains at the time of the incorporation transaction, or should it be extended to all corporate-level gains, whether they arose before or after the formation of the corporation? Finally, should any such relief be conditioned upon the elimination of a death step-up under section 1014, as was suggested by the Treasury Department?[176] These and other issues raised significant problems of added complexity and potential uncertainty.

Another form of relief provided under the bill is the special election for goodwill and other unamortizable intangibles. Thus, at the election of the taxpayer, the corporate level tax burden of a cost basis election would not include any tax on the appreciation of such intangibles. This relief would not be inconsistent with the repeal of *General Utilities* because the acquiring party would be required to obtain a carryover basis in the intangibles.

A third form of relief is available under Subchapter S. Under current law, a C corporation with appreciated assets may be able to elect S corporation status and thereby avoid the corporate level tax on the appreciation. The bill would limit that possibility by generally not permitting an increase to a shareholder's stock basis in the case of gain (other than gain on long-held capital assets) recognized by the corporation which is attributable to periods when the corporation was a C corporation.[177] (This would have the effect of maintaining a potential "double tax" on gain (other than gain on long-held capital assets) arising when the corporation was a C corporation.) However, the S corporation modifications do not apply to corporations with a fair market value of $1 million or less, and apply only with limited impact to corporations under $2 million in value. This proposal, in combination with the shareholder credit proposal, should permit maximum flexibility in providing sharholder relief to small corporations.

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[175] *See* Roche testimony at 284.

[176] *See* Pearlman testimony at 29-30.

[177] The actual proposal permits an increase in stock basis to reflect the taxable portion of the gain. Thus, a tax-free distribution could be made by the S corporation to its shareholders to enable the shareholders to pay the pass-through tax on the corporate-level gain. Distributions in excess of that, however, would be taxable to the shareholders.

A final form of relief provided is transitional relief. Although it was believed the existence of permanent relief would eliminate much of the need for transitional relief, it seemed appropriate to provide a specific prospective period of time during which businesses and investors could adjust to the new rules. Accordingly, the bill will not be effective any earlier than January 1, 1986.[178]

Two other forms of relief are not specifically included in the bill, but are recommended, contingent upon certain other factors. First, in its November, 1984 Report to the President, the Treasury Department recommended an across-the-board 50 percent dividends paid deduction for all corporations.[179] If that proposal, as well as the additional Treasury proposal to eliminate the capital gains preference, is enacted, it is recommended that the same relief should be considered in the case of liquidating distributions. The basis adjustment proposal could then be repealed if this relief were provided.

Second, to the extent necessary to keep this bill revenue-neutral, it is recommended that consideration be given to an across-the-board reduction of the corporate capital gains tax rate.

### *E. Net operating losses*

Current law rules limiting the carryover of net operating losses present a number of significant problems. From a conceptual standpoint, the principal problem is that the current law rules base their limitation upon the amount of the loss carryover as opposed to the amount of consideration paid in the transaction. This creates a rule which is, at once, too harsh and too generous. As stated by the American Law Institute:

> Existing law is too harsh when it disallows any part of loss carryover that is only a minor incident in an acquisition transaction; at the same time it is too lenient, assuming we are to have any limitations at all, when it allows any fraction of a loss carryover in the absence of any other elements of value.[180]

Aside from the conceptual difficulties, the rules themselves fail to provide any consistent pattern or policy. For example, overlapping section 382 in some respects is section 269 of the Code.[181] Section 269 may help to preclude the acquisition of shell corporations with losses, or to deter acquisitions where economic substance is nonexistent. Other than that, however, by inserting an inherently uncertain, subjective test into the rule structure, section 269 may serve little purpose beyond discounting the value of the loss corporation to the seller and increasing the amount of the buyer's windfall.

Section 382(a) of current law provides an all-or-nothing test for the continuation of net operating loss carryovers, dependent largely upon whether a historic trade or business has continued. Obviously, the continuation of a trade or business raises difficult definitional problems. In addition, however, the rule tends to encourage the continuation of non-economic lines of business, merely to insure the survival of tax benefits.

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[178] The Treasury Department suggested the possibility of a deferred effective date. Pearlman testimony at 23.

[179] *See* Treasury Department Tax Reform Proposals, Vol. II at 134-44.

[180] American Law Institute, *Federal Income Tax Project; Subchapter C*, (1982) at 201.

[181] The exact extent of overlap is not completely clear. For example, each section generally applies upon a change in ownership or control of a corporation, but the exact parameters of such a change are defined differently in section 269(a)(1), section 269(a)(2), section 382(a), and section 382(b).

Section 382(b) of current law is also flawed. The operation of that provision turns upon whether a very small percentage (*i.e.*, 20 percent) of the shareholders of the loss corporation acquire an interest in the acquiring corporation. Moreover, section 382(b) does not apply to a "B" reorganization and certain subsidiary reorganizations.

The 1976 Reform Act rules eliminate certain of the discontinuities and uncertainties of current law. However, implementation of the rules have now been deferred for 10 years, and it does not seem likely that they will ever be enacted. Moreover, the 1976 Act rules suffer from the same fundamental flaws as the 1954 rules.

For example, assume that L has no assets other than net operating loss carryovers of $20 million. P has pre-tax income of $1 million per year and pays annual tax of approximately $460,000. If L is merged into P, with the L shareholders receiving 20 percent of P's stock in the transaction, the 1976 rules would reduce L's carryover by 70 percent, to $6 million.

In this example, despite the reduction in the carryover, the transaction may still be consummated solely because of the tax benefits provided to P. Other than section 269, the 1976 rules would not preclude a purely tax-motivated transaction.

In contrast, assume that L has net operating losses of $10 million and other assets valued at $50 million. If L is merged into P, with the L shareholders receiving 20 percent of the P stock, the 1976 rules would similarly reduce the carryover by 70 percent, to $3 million. Here, the rules would limit the carryover even though the tax benefits are a relatively small element in the transaction.

The September, 1983 Staff Report proposed a fundamental change in the method by which net operating loss carryovers and other carryforwards would be limited in an acquisition. According to the original proposal, the use of net operating losses by an acquiring party after an acquisition would generally be limited to the use of such losses by the target corporation, had no acquisition taken place. This general approach was consistent with the American Law Institute study, and was very favorably received at the October hearing.[182]

The proposed implementation of that general approach, however, met with considerable opposition.[183] The original proposals contained in the Staff Report would have provided one limitation rule (the "purchase" rule) in the case of stock purchases, redemptions, and qualified acquisitions to the extent the consideration did not consist of qualifying consideration, and a separate rule (the "merger" rule) in the case of qualified acquisitions (to the extent the consideration did consist of qualifying consideration), and changes in ownership resulting from the issuance of new stock in exchange for cash or other property. The opposition to the original proposals related primarily to the concern that the merger rule, as well as the interplay between the two rules, was excessively complex.[184]

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[182] *See* footnote 40, *supra.*

[183] *See* footnotes 41 and 42, *supra.*

Under the proposed merger rule, the portion of post-acquisition income that could be offset by pre-acquisition net operating loss carryovers of the loss corporation would generally be limited to the income generated by the assets contributed by the loss corporation. Although theoretically sound, there was concern that the actual determination of the amount of earnings allocable to the assets contributed by the loss corporation would be extremely complex. This would especially be the case where the consideration consisted not just of common stock of the acquiring corporation but also of other forms of equity.

A more significant problem with the merger rule was the issue of disguised capital contributions. A pure merger rule would not apply any limitations to the use of net operating loss carryovers so long as the "pool of capital" of the corporation were unchanged. Thus, for example, there would generally be no limitation upon a taxable purchase of stock for cash. The problem with the foregoing, however, was the concern that new owners of the loss corporation would have an incentive to accelerate the use of net operating losses by augmenting the original pool of capital by means of capital contributions or other schemes. It was for this reason that the American Law Institute originally proposed the "purchase" rule limitation as well as the "merger" rule.[185] It was for the same reason that the original Staff Report proposed including a purchase rule as well as a merger rule.

There was concern that a two-rule approach would be excessively complex, especially in those overlap transactions where both rules would apply in part. For example, under the original formulation, if an acquiring corporation issued stock and boot in a qualified acquisition, both the purchase and merger rules would apply in part.

Some consideration was given to proposing a single "merger" rule, and simply retaining or strengthening section 269 to deal with the case of disguised capital contributions. Aside from the difficulties with the merger rule itself, this approach was rejected because it would bring back many of the problems and uncertainties of current law that the proposal was trying to eliminate. Adoption of a single purchase rule did not present the same problems, since it could provide an effective limitation rule in all cases, without the application of section 269.

The bill, therefore, proposes a single purchase rule, limiting the use of net operating loss carryovers and other carryforwards after there has been a more than 50 percent change in ownership of the corporation. The limitation per year is generally equal to the value of the loss corporation at the time of the change multiplied by the applicable Federal long-term rate under section 1274(d).

Under a pure "neutrality" principle, the use of carryovers after an ownership change should be limited to the use that would have been available to the loss corporation, had there been no change. Under this principle, the tax laws relating to carryovers would provide neither an incentive nor a disincentive for the change in control.

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[184] *See* footnote 42, *supra*. The Tax Section of the American Bar Association recently recommended that a single purchase-type rule be adopted.

[185] *See* American Law Institute, *Federal Income Tax Project: Subchapter C*, (1982) at 23-34.

In attempting to derive a formula to accomplish the neutrality principle, it was necessary, therefore, to ascertain the rate a loss corporation would use its carryovers if there were no change in control. Based upon statistics provided by the Joint Tax Committee's corporate tax model, it was determined that the "absorption" rate for a typical loss corporation, as a percent of book net worth, was approximately 4.4 percent, and the absorption rate of *all* corporations was about 6.5 percent.[186] The absorption rate is a measure of how quickly net operating losses can be used by a corporation to offset taxable income. In other words, assuming a loss corporation has book net worth of $100, it would ordinarily be able to use only about $4.40 of net operating losses each year to offset taxable income.[187]

These statistics suggested that a proper limitation formula under section 382 would limit the use of carryovers after a change in control to between 4.4 percent and 6.5 percent of the value of the loss corporation.[188] Two reasons were articulated as to why such a formula might not be appropriate. First, it was argued that the formula only addressed the "average" situation, and did not give any credence to the possibility of the "turnaround" case, where the loss corporation performed dramatically better after the change in control. One might question, however, why a historical loss corporation should reasonably be expected to perform markedly better after an ownership change than the average for *all* corporations, profitable and loss. Further, any true "turnaround" cases would probably be offset by cases where the loss corporation does markedly *worse* after the control change. In such a case, of course, the 4.4 percent to 6.5 percent formula would be very generous.

More significantly, it was asserted that the formula did not take into account the fact that the loss corporation could simply liquidate its assets and purchase taxable securities, yielding a steady, risk-free flow of taxable income which could be offset by any available losses. This would at least maximize the use of carryovers by the loss corporation, although it might not maximize the after-tax rate of return of the corporation.

It was decided, therefore, that the "neutrality" principle should be implemented by assuming that the loss corporation, in all cases, would maximize the use of its carryovers, had there been no control change. This, obviously, represented an extremely generous assumption. The long-term Federal rate was selected because it is based on an average of long-term Treasury bond rates, the maximum risk-free rate of return the loss corporation could have obtained. A long-term, as opposed to a short-term, rate was selected because it was assumed that maximum use of losses would be desired for the full potential 15-year carryover period.

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[186] The "absorption" rate is defined as the tax liability of the corporation before carryovers divided by the maximum corporate tax rate (46 percent).

[187] These figures do not seem unreasonable when it is realized that the effective tax rate for corporations is only approximately 16 percent, rather than the highest marginal tax rate of 46 percent. *See* "Study of 1983 Effective Tax Rates of Selected Large U.S. Corporations," prepared by the Staff of the Joint Committee on Taxation (November 28, 1984).

[188] Even this result might be too high because book net worth may be a conservative estimate of value. To the extent value exceeds book net worth, there would have to be a corresponding reduction in the prescribed rate. Furthermore, the Joint Tax Committee study did not include a representative sample of those loss corporations that are unable to utilize their losses at all. Including a fair sample of such corporations would tend to lower the average absorption rate.

### *F. Publicly-traded limited partnerships*

As noted, most people who testified on the proposal relating to publicly-traded limited partnerships opposed the Staff Report recommendation which would have treated such entities as corporations for tax purposes.[189] Certain of the testimony must be discounted because the witnesses represented the limited partnerships that would be affected by the proposal. It would not be expected that those witnesses would testify in favor of a proposal adversely affecting them from a tax standpoint.

Of the other witnesses who testified on the subject, several favored the proposal,[190] several opposed it, and several recommended more time to consider it.[191] Of particular significance was the testimony favoring the proposal of Donald Alexander, former Commissioner of the Internal Revenue Service, who stated:

> I believe that limited partnerships with publicly-traded partnership interests should, in general, be considered associations taxable as corporations under section 7701(a)(3) of the Code. . . . Treas. Reg. sec. 301.7701-1, -2, and -3 are the source of the problem; designed to thwart physicians who sought equity in pension planning (a goal secured by court decisions and later by legislation), they failed in the their purpose but instead succeeded in permitting what are truly associations to be misclassified as partnerships with all attendant conduit benefits. It is too late to correct the mistake made in the 1960 Regulations, but it is time to remedy this long-festering problem by legislation. Subject to fair and reasonable transitional rules which recognize economic and investor realities created by the Regulations, giant publicly-traded entities which now masquerade as partnerships should be taxed as corporations.[192]

The Treasury Department opposed the proposal, primarily because it involved tax policy considerations beyond the scope of the project.[193]

At the hearing, several witnesses representing large publicly-traded limited partnerships were asked to explain the non-tax business differences between a shareholder of a corporation and an investor in a publicly-traded limited partnership. The general thrust of the responses was that the principal differences related to the tax consequences to the shareholder or to the investor.[194] No non-tax business reason for forming the entity as a publicly-traded limited partnership rather than as a corporation was articulated.

Since the time of the October, 1983 hearing, the Treasury Department, in its recommendations to the President, has proposed classifying all limited partnerships with more than 35 limited partners as corporations for tax purposes.[195] Because all existing publicly-traded limited partnerships have over 35 limited partners, the Treasury Department proposal necessarily subsumes the original Staff Report recommendation. It was determined that, rather than approach the issue in a piecemeal fashion, further action on the

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[189] *See* footnotes 46 and 47, *supra.*

[190] *See* footnote 46, *supra.*

[191] *See* footnote 50, *supra.*

[192] Alexander testimony at 135.

[193] Pearlman testimony at 63.

[194] *See* questioning by Senator Danforth at 376–79.

[195] Treasury Tax Reform Proposals, Vol. II at 146–50.

Staff Report proposal should await any developments with respect to the Treasury proposal. This seemed particularly appropriate in view of Treasury's original concern that the Staff Report recommendation was beyond the scope of, and not necessary to, the overall Subchapter C project.

Accordingly, the bill at this time does not contain any proposal regarding publicly-traded limited partnerships.

### *G. Further proceedings*

There is no question that the proposals contained in this bill represent significant revisions to Subchapter C of the Code, and potentially may affect many corporations and their investors. It is also true, however, that these proposals have been under consideration for an extended period of time. Certain of the proposals originate with ideas set forth over 25 years ago. Many others are based upon an 8-year study of the American Law Institute, completed in 1982.

Since October, 1982, when the Chairman of the Finance Committee initiated the project, a number of meetings have been held with an outstanding group of outside academicians and tax practitioners to formulate and review the proposals. In addition, countless hours have been spent reviewing and considering other suggestions and recommedations brought to the Committee's attention. A preliminary report was issued in September, 1983 and a hearing was held in October, 1983. This bill now provides specific statutory language implementing the proposals along with extensive explanatory materials. It has been quite some time since tax proposals have received the degree of careful attention and review that the proposals contained in this bill have received.

It is hoped that those most affected by these proposals will take the opportunity to review them carefully, and to provide constructive comments, suggestions, and criticisms to improve the final product.

# PART TWO: PROPOSED STATUTORY AMENDMENTS

7

99TH CONGRESS
1ST SESSION

# S.

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IN THE SENATE OF THE UNITED STATES

Mr.____introduced the following bill; which was read twice and referred to the Committee on ____

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# A BILL

To revise subchapter C of chapter 1 of the Internal Revenue Code of 1954 (relating to corporate distributions and adjustments).

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

## SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Subchapter C Revision Act of 1985".

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(b) Amendment of 1954 Code.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) Table of Contents.—

Sec. 1. Short title; amendment of 1954 Code; table of contents.

## TITLE I—GENERAL REVISION OF SUBCHAPTER C

### Subtitle A—Corporate Organizations and Acquisitions

Sec. 101. Corporate organizations and acquisitions.

### Subtitle B—Corporate Distributions

Sec. 111. Corporate recognition of gain or loss on distributions of property by corporations.

### Subtitle C—Corporate Liquidations

Sec. 121. Repeal of sections 336, 337, 338, and 341.
Sec. 122. Modification of section 333 election.
Sec. 123. Effective dates.

### Subtitle D—Technical and Conforming Changes

Sec. 131. Technical and conforming changes.

## TITLE II—PROVISIONS RELATING TO GAIN AND LOSS OF SHAREHOLDERS OF CORPORATIONS

### Subtitle A—Basis Adjustments

Sec. 201. Basis of controlling corporate shareholder in subsidiary.
Sec. 202. Basis adjustments to reflect corporate level tax paid in certain corporate acquisitions and liquidations.

### Subtitle B—Other Provisions Relating to Gain or Loss

Sec. 211. No gain or loss recognized on exchange of stock of controlling corporation.
Sec. 212. Character of gain on disposition of certain property by corporation determined by reference to shareholders.
Sec. 213. Amendments to section 1248.
Sec. 214. Modifications relating to subchapter S.
Sec. 215. Effective dates.

TITLE III—LIMITATIONS ON TAX CARRYOVERS

Sec. 301. Short title.
Sec. 302. Limitations on tax carryovers.

# TITLE I—GENERAL REVISION OF SUBCHAPTER C

## SUBTITLE A—CORPORATE ORGANIZATIONS AND ACQUISITIONS

### SEC. 101. CORPORATE ORGANIZATIONS AND ACQUISITIONS.

**(a)** IN GENERAL.—Part III of subchapter C of chapter 1 (relating to corporate organizations and reorganizations) is amended to read as follows:

## "PART III—CORPORATE ORGANIZATIONS AND ACQUISITIONS

"Subpart A—Corporate organizations.
"Subpart B—Effects on shareholders and security holders.
"Subpart C—Effects on corporations.
"Subpart D—Definitions and special rules.

### "subpart a—corporate organizations

"Sec. 351. Transfer to corporation controlled by transferor.

### "SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

"(a) GENERAL RULE.—No gain or loss shall be recognized if—

"(1) property is transferred to a corporation by 1 or more persons solely in exchange for stock and securities in such corporation, and

"(2) immediately after the exchange such person or persons are in control (within the meaning of section 366(c)) of the corporation.

"(b) SUBSECTION (a) NOT TO APPLY TO RECEIPT OF CERTAIN SECURITIES.—Subsection (a) shall not apply to the extent that the issue price of securities of the transferee corporation received exceeds the adjusted basis of any securities of the transferee corporation surrendered.

"(c) RECEIPT OF NONQUALIFYING CONSIDERATION.—If subsection (a) would apply to an exchange but for the fact that any person receives nonqualifying consideration (within the meaning of section 366(f)), then—

"(1) gain (if any) to such recipient shall be recognized, but not in excess of the fair market value of the nonqualifying consideration, and

"(2) no loss to such recipient shall be recognized.

"(d) EXCEPTIONS.—This section shall not apply to—

"(1) QUALIFIED ACQUISITIONS.—Except as provided in regulations, a transfer which qualifies as a qualified acquisition.

"(2) TRANSFER OF PROPERTY TO AN INVESTMENT COMPANY.—A transfer of property to an investment company.

"(3) TITLE 11 OR SIMILAR CASE.—A transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 366(h)) to the extent that the stock or securities received in the exchange are used to satisfy the indebtedness of such debtor.

"(e) SPECIAL RULES.—For purposes of this section—

"(1) CONTROL.—In determining control, there shall not be taken into account the fact that—

"(A) any corporate transferor distributes part or all of the stock which it receives in an exchange to its shareholders, or

"(B) there is a qualified acquisition of the transferee immediately following the exchange, but only if—

"(i) the transferor is a corporation, and

"(ii) the assets transferred constitute such assets as are sufficient for the active conduct of a trade or business (within the meaning of section 355(b)(2), but without regard to the 5-year requirement) by the transferee.

"(2) SPECIAL RULE FOR INSTALLMENT SALES BETWEEN CORPORATIONS AND 20 PERCENT SHAREHOLDERS.—

"(A) IN GENERAL.—If—

"(i) 1 or more persons transfer property to a corporation in an installment sale (within the meaning of section 453(b)) with respect to which an election under section 453(d) was not made, and

"(ii) immediately after the transfer such person or persons are in control of such corporation,

then such transfer shall be treated as an exchange to which this section applies.

"(B) CONTROL.—For purposes of this paragraph, the term 'control' has the meaning given such term by section 366(c), except that in applying section 1504(a)(2), '20 percent' shall be substituted for '80 percent'.

"(3) SERVICES, CERTAIN INDEBTEDNESS, AND ACCRUED INTEREST NOT TREATED AS PROPERTY.—Any stock or securities issued for—

"(A) services,

"(B) indebtedness of the transferee corporation which is not evidenced by a security, or

"(C) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt, shall not be considered as issued in return for property.

"(f) CROSS REFERENCES.—

**"(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.**

**"(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.**

**"(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.**

**"(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).**

**"(5) For coordination of this section with section 304, see section 304(b)(3).**

## "Subpart B—Effect on Shareholders

"Sec. 354. Nonrecognition of gain or loss to shareholders in exchanges of stocks and securities in qualified acquisitions.
"Sec. 355. Distribution of stock and securities of a controlled corporation.
"Sec. 356. Receipt of nonqualifying consideration.
"Sec. 357. Assumption of liability.
"Sec. 358. Basis to distributees.

### "SEC. 354. NONRECOGNITION OF GAIN OR LOSS TO SHAREHOLDERS IN EXCHANGES OF STOCK AND SECURITIES IN QUALIFIED ACQUISITIONS.

"(a) NONRECOGNITION OF GAIN OR LOSS.—In the case of a qualified acquisition, no gain or loss shall be recognized by any shareholder or security holder of the target corporation if such shareholder or security holder exchanges—

"(1) stock or securities of the target corporation solely for,

"(2) stock or securities of a corporation which is a party to the acquisition.

"(b) QUALIFIED STOCK ACQUISITIONS TO INCLUDE ACQUISITIONS AFTER CORPORATION OBTAINS CONTROL.—For purposes of subsection (a), the term 'qualified stock acquisition' includes the acquisition by 1 corporation of stock in another corporation if, immediately after such acquisition, the acquiring corporation has control of such other corporation (whether or not the acquiring corporation had control immediately before the acquisition). For purposes of the preceding sentence, if the acquiring corporation is a member of an affiliated group, the acquiring corporation shall be treated as holding stock of the other corporation held by other members of such group.

"(c) SPECIAL RULE FOR STOCK ACQUIRED IN ASSET ACQUISITION.—For purposes of subsection (a), section 364(e)(1) (relating to separate treatment of stock acquired in an asset acquisition) shall not apply and any stock described in section 364(e)(1) shall be treated as acquired in a qualified asset acquisition.

"(d) LIMITATIONS ON NONRECOGNITION.—

"(1) CERTAIN EXCHANGES INVOLVING INVESTMENT COMPANY STOCK.—

"(A) IN GENERAL.—Subsection (a) shall not apply to any exchange of stock or securities of a target corporation for stock or securities of any party to the acquisition which is an investment company.

"(B) EXCEPTION WHERE TARGET CORPORATION A DIVERSIFIED INVESTMENT COMPANY FOR 12 OUT OF LAST 16 QUARTERS.—Subparagraph (A) shall not apply in any case where the target corporation was a diversified investment company—

"(i) on the last day of 12 of the last 16 calendar quarters ending before the acquisition date, or

"(ii) if the target corporation has been in existence for less than 16 calendar quarters, during such period as the Secretary may prescribe in regulations.

"(2) SPECIAL RULE FOR SECURITIES.—Subsection (a) shall not apply to the extent that the issue price of any securities of a party to the acquisition received exceeds the adjusted basis of any securities of the target corporation surrendered.

"(3) PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST.—Neither subsection (a) nor so much of section 356 as relates to subsection (a) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

"(4) CROSS REFERENCES.—

**"(A) For treatment of the exchange in the case of nonqualifying consideration, see section 356.**

**"(B) For treatment of accrued interest in the case of an exchange described in paragraph (3), see section 61.**

"(e) DIVERSIFIED INVESTMENT COMPANY DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'diversified investment company' means any investment company with respect to which—

"(A) not more than 25 percent of the fair market value of its total assets is invested in stock and securities of any 1 issuer, and

"(B) not more than 50 percent of the fair market value of its total assets is invested in stock and securities of 5 or fewer issuers.

For purposes of this paragraph, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as 1 issuer.

"(2) INVESTMENT COMPANY.—The term 'investment company' means—

"(A) a regulated investment company,

"(B) a real estate investment company, or

"(C) any other corporation if—

"(i) 50 percent or more of the fair market value of the assets of such corporation consist of stock or securities, and

"(ii) 80 percent or more of the fair market value of the assets of such corporation are held for investment.

"(3) SPECIAL RULES FOR APPLICATION OF THIS SUBSECTION.—For purposes of this subsection—

"(A) STOCK AND SECURITIES OF CONTROLLED SUBSIDIARY.—If a corporation owns stock representing control of another corporation—

"(i) the stock and securities of such other corporation shall not be taken into account, and

"(ii) the controlling corporation's pro rata share of the assets of such other corporation shall be taken into account.

For purposes of this subparagraph, in determining control under section 366(c), section 1504(a)(2) shall be applied by substituting '50 percent' for '80 percent'.

"(B) CERTAIN ASSETS NOT TAKEN INTO ACCOUNT.—None of the following items shall be taken into account in computing the total assets of a corporation:

"(i) Cash and cash items (including receivables).

"(ii) Government securities with a maturity (at issue) of 3 years or less.

"(iii) Under regulations prescribed by the Secretary, assets acquired (through incurring indebtedness or otherwise) or disposed of for purposes of trying to become, or ceasing to be, an investment company.

"(4) SECURITIES DEFINED.—For purposes of this subsection (other than paragraph (3)(B)), the term 'securities' includes obligations of State and local governments, shares of regulated investment companies and real estate investment trusts, and any security, commodity, or interest described in subparagraph (A), (B), or (C) of section 1246(b)(2).

### "SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

"(a) EFFECT ON DISTRIBUTEES.—

"(1) GENERAL RULE.—If—

"(A) a corporation (referred to in this section as the "distributing corporation")

"(i) distributes to a shareholder, with respect to its stock, or "(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as the "controlled corporation") which it controls immediately before the distribution,

"(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both,

"(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

"(D) as part of the distribution, the distributing corporation distributes—

"(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

"(ii) an amount of stock in the controlled corporation constituting control (within the meaning of section 366(c)), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

"(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

"(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation, and

"(B) whether or not the shareholder surrenders stock in the distributing corporation.

"(3) LIMITATIONS.—

"(A) SPECIAL RULE FOR SECURITIES.—Paragraph (1) shall not apply to the extent that the issue price of the securities in the controlled corporation which are received exceeds the adjusted basis of the securities in the distributing corporation which are surrendered in connection with such distribution.

"(B) STOCK ACQUIRED IN TAXABLE TRANSACTIONS WITHIN 5 YEARS TREATED AS BOOT.—For purposes of this section (other than paragraph

(1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—

"(i) which occurs within 5 years of the distribution of such stock, and

"(ii) in which gain or loss was recognized in whole or in part,

shall not be treated as stock of such controlled corporation, but as nonqualifying consideration.

"(C) PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST.—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

"(4) CERTAIN SALES OR EXCHANGES NOT TREATED AS DEVICES.—For purposes of paragraph (1)(B), the mere fact that stock or securities in the distributing or controlled corporation are sold or exchanged after the distribution by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as a device for the distribution of earnings and profits.

"(5) CROSS REFERENCES.—

**"(A) For treatment of nonqualifying consideration, see section 356.**

**"(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61.**

"(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

"(1) IN GENERAL.—Subsection (a) shall apply only if either—

"(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

"(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

"(2) ACTIVE CONDUCT OF TRADE OR BUSINESS.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

"(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

"(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

"(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

"(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

"(i) was not acquired directly (or through 1 or more corporations) by another corporation within the period described in subparagraph (B), or

"(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

### "SEC. 356. RECEIPT OF NONQUALIFYING CONSIDERATION.

"(a) RECOGNITION OF GAIN ON RECEIPT OF NONQUALIFYING CONSIDERATION IN SECTION 354 OR 355 EXCHANGE.—Except as provided in this section, if section 354 or 355 would apply to an exchange but for the fact that any shareholder or security holder receives nonqualifying consideration, then such shareholder or security holder shall recognize gain (if any), but in an amount not in excess of the fair market value of the nonqualifying consideration.

"(b) NONQUALIFYING CONSIDERATION RECEIVED IN CERTAIN SECTION 355 DISTRIBUTIONS.—If section 355 would apply to a distribution but for the fact that any shareholder or security holder receives nonqualifying consideration, then an amount equal to the fair market value of such nonqualifying consideration shall be treated as having been received by such shareholder or security holder in a distribution of property to which section 301 applies.

"(c) RECOGNITION OF LOSS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), no loss shall be recognized on any exchange or distribution described in subsection (a) or (b).

"(2) EXCEPTION WHERE SHAREHOLDER RECEIVED NO STOCK OR SECURITY HOLDER RECEIVED

NO STOCK OR SECURITIES.—In the case of any exchange to which subsection (a) applies, any—

"(A) shareholder who exchanges stock and who does not receive—

"(i) any stock of a party to the acquisition, or

"(ii) in the case of an exchange to which section 355 applies, any stock of the controlled corporation, and

"(B) security holder who exchanges securities and who does not receive—

"(i) any stock or securities of a party to the acquisition, or

"(ii) in the case of an exchange to which section 355 applies, any stock or securities of the controlled corporation,

shall recognize loss (if any) on such exchange.

"(d) SPECIAL RULES WHERE ALL OR PORTION OF EXCHANGE HAS THE EFFECT OF A DIVIDEND.—

"(1) IN GENERAL.—If an exchange described in subsection (a) has the effect of a distribution of a dividend, then subsections (a) and (c)(2) shall not apply and each shareholder shall be treated as having received a dividend equal to the lesser of—

"(A) the fair market value of any nonqualifying consideration received by such shareholder, or

"(B) the shareholder's ratable share of undistributed earnings and profits accumulated after February 28, 1913, of—

"(i) in the case of an exchange to which section 354 applies, the target corporation, and any party to the acquisition the stock or securities of which were received by such shareholder, or

"(ii) in the case of an exchange to which section 355 applies, the distributing corporation, and any controlled corporation the stock or securities of which were received by such shareholder.

"(2) TREATMENT OF GAIN WHERE GAIN EXCEEDS AMOUNT TREATED AS DIVIDEND.—If—

"(A) the amount of gain recognized under subsection (a) (determined without regard to this subsection), exceeds

"(B) the amount treated as a dividend under paragraph (1),

then the amount of such excess shall be treated as gain from the exchange of property.

"(3) SPECIAL RULES FOR DETERMINING WHETHER EXCHANGE UNDER SECTION 354 HAS EFFECT OF DISTRIBUTION OF DIVIDEND.—For purposes of this subsection, in determining whether an exchange under section 354 of stock of the target corporation by any shareholder has the effect of a distribution of a dividend—

"(A) the shareholder shall be treated as having exchanged on the acquisition date—

"(i) stock of the target corporation, for

"(ii) stock of any party to the acquisition received by such shareholder, and

"(B) the receipt of nonqualifying consideration shall be treated as a redemption on the acquisition date—

"(i) of all or a portion of such stock of such party to the acquisition, and

"(ii) to which section 302 applies.

"(4) SECTION 355 EXCHANGES.—For purposes of determining whether an exchange under section 355 of stock of the distributing corporation has the effect of a distribution of a dividend, the receipt of nonqualifying consideration shall be treated as a redemption of the stock of the distributing corporation to which section 302 applies.

"(e) SPECIAL RULES FOR CONTROLLING CORPORATE SHAREHOLDERS IN QUALIFIED ACQUISITIONS.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), if a controlling corporate shareholder of a target corporation (determined before the acquisition date) receives nonqualifying consideration in connection with a qualified acquisition—

"(A) section 332 shall not apply,

"(B) notwithstanding subsection (c)(2), no loss shall be recognized by such shareholder, and

"(C) notwithstanding subsection (a), no gain shall be recognized by such shareholder but only if such qualified acquisition is a—

"(i) cost basis acquisition, or

"(ii) carryover basis acquisition and such shareholder distributes all of its assets (other than assets retained to meet claims) to its shareholders or creditors within 12 months of the acquisition date.

Except as provided in regulations, section 332 shall not apply to any distribution described in subparagraph (C)(ii).

"(2) SPECIAL RULE WHERE ACQUISITION TREATED AS COST AND CARRYOVER BASIS ACQUISITION.—In any case to which section 364(e) (relating to stock acquired in asset acquisition) or section 365(b)(2) (relating to carryover treatment of unamortizable property) applies (relating to cost basis acquisitions or carryover basis acquisitions followed by a distribution of all assets), subparagraph (C)(i) of paragraph (1) shall not apply to any gain of the controlling corporate shareholder to the extent of the lesser of—

"(A) the net gain of the target corporation allocable to the assets treated as acquired in a carryover basis acquisition, or

"(B) the fair market value of the nonqualifying consideration received by the controlling corporate shareholder.

"(3) SPECIAL RULE FOR CERTAIN FOREIGN CORPORATIONS.—Subparagraph (C)(i) of paragraph (1) shall not apply to the extent that the income of a target corporation which is a foreign corporation is not subject to tax under section 882.

"(f) EXCHANGES FOR SECTION 306 STOCK.—

"(1) IN GENERAL.—Notwithstanding any other provision of this section, to the extent that any nonqualifying consideration is received in exchange for section 306 stock, an amount equal to the lesser of—

"(A) the fair market value of such nonqualifying consideration, or

"(B) the recipients' ratable share of undistributed earnings and profits which were accumulated after February 28, 1913, of any corporation described in subsection (d)(1)(B),

shall be treated as a distribution of property to which section 301 applies.

"(2) EXCEPTION WHERE SHAREHOLDER IN SECTION 354 EXCHANGE RECEIVED NO QUALIFYING CONSIDERATION.—In the case of any exchange to which section 354 applies, this subsection shall not apply to any shareholder of the target corporation who did not receive any qualifying consideration.

### "SEC. 357. ASSUMPTION OF LIABILITY.

"(a) GENERAL RULE.—If—

"(1) section 351, 354, 355, or 356 applies to an exchange, and

"(2) as part of the consideration, another party to the exchange assumes any qualified indebtedness of the transferor, or acquires from the transferor property subject to any qualified indebtedness,

then such assumption or acquisition shall not be treated as nonqualifying consideration.

"(b) QUALIFYING INDEBTEDNESS.—

"(1) In general.—The term 'qualifying indebtedness' means, with respect to any exchange, any liability—

"(A) incurred by the transferor to acquire any property transferred in such exchange, or

"(B) with respect to which—

"(i) the transferee assumes such liability, or

"(ii) the transferee takes property subject to such liability,

incident to the transferee's acquisition, holding, or operation of the property transferred in the ordinary course of business.

"(2) Qualified indebtedness in excess of basis in section 351 exchanges.—

"(A) In general.—In the case of an exchange to which section 351 applies, if—

"(i) the sum of the amount of the qualified indebtedness assumed, plus the amount of the qualified indebtedness to which the property is subject, exceeds

"(ii) the total of the adjusted basis of the property transferred pursuant to such exchange, then the qualifying indebtedness shall be reduced by the amount of such excess.

"(B) CERTAIN LIABILITIES EXCLUDED.—

"(i) IN GENERAL.—If a taxpayer transfers, in an exchange to which subparagraph (A) applies, a liability the payment of which either—

"(I) would give rise to a deduction, or

"(II) would be described in section 736(a),

then, for purposes of subparagraph (A), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

"(ii) EXCEPTION.—Clause (i) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

**"SEC. 358. BASIS TO DISTRIBUTEES.**

"(a) QUALIFYING CONSIDERATION.—

"(1) IN GENERAL.—Except as provided in paragraph (2) and subsection (c), in the case of an exchange to which section 351, 354, 355, or 356 applies, the basis of any qualifying consideration received in such exchange shall be equal to the basis of the property for which it was exchanged—

"(A) decreased by the fair market value of nonqualifying consideration received by such recipient, and

"(B) increased by—

"(i) the amount which was treated as a dividend, and

"(ii) the amount of gain to such recipient which was recognized on such exchange, but such gain—

"(I) shall not include any portion of such gain which was treated as a dividend, and

"(II) shall include any gain which would be recognized at the time of the exchange but for section 453.

"(2) SPECIAL RULE FOR SECTION 351 EXCHANGES.—In the case of an exchange to which section 351 applies, if the fair market value of the property transferred to the corporation at the time of the exchange is less than the adjusted basis of such property, paragraph (1) shall be applied by substituting such value for such basis.

"(b) NONQUALIFYING CONSIDERATION.—In the case of any exchange to which section 351, 354, 355, 356, or 361 applies, the basis of any nonqualifying consideration received in such exchange shall be the fair market value of such property at the time of the exchange.

"(c) CONTROLLING CORPORATE SHAREHOLDERS IN QUALIFIED ACQUISITION.—In the case of any controlling corporate shareholder of a target corporation (determined before the acquisition date)—

"(1) QUALIFYING CONSIDERATION.—The basis of any qualifying consideration received by a controlling corporate shareholder in a qualified acquisition shall be equal to the lesser of—

"(A) the basis of the stock or securities of the target corporation for which such consideration was exchanged, or

"(B) the fair market value of the qualifying consideration.

"(2) SPECIAL RULE FOR CERTAIN ACQUISITIONS.—Except as provided in regulations, in any case to which section 356(e)(1)(C) applies (relating to cost basis acquisitions or carryover basis acquisitions followed by a distribution of all assets), the basis of any qualifying consideration received by the controlling corporate shareholder shall be the fair market value of such consideration.

"(3) SPECIAL RULE FOR RECAPITALIZATIONS AND CHANGES IN IDENTITY, ETC.—In the case of any qualified acquisition described in section 364(g), the basis of any qualifying consideration received by the controlling corporate shareholder shall be the amount determined under paragraph (1)(A).

"(d) ALLOCATION OF BASIS.—

"(1) IN GENERAL.—Under regulations, the basis determined under subsection (a) shall be allocated among the qualifying consideration received.

"(2) SPECIAL RULE FOR SECTION 355.—In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the qualifying consideration received, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

"(e) SECTION 355 TRANSACTIONS WHICH ARE NOT EXCHANGES.—For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

"(f) ASSUMPTION OF LIABILITY.—

"(1) IN GENERAL.—Where, as part of the consideration to the taxpayer, another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as nonqualifying consideration.

"(2) EXCEPTION.—Paragraph (1) shall not apply to the amount of any liability excluded under section 357(b)(2)(B).

## "Subpart C—Effect on Corporations

"Sec. 361. Treatment of qualified acquisitions.
"Sec. 362. Basis to corporations in organizations and qualified acquisitions.

### "SEC. 361. TREATMENT OF QUALIFIED ACQUISITIONS.

"(a) CARRYOVER BASIS ACQUISITION.—In the case of a carryover basis acquisition, no gain or loss shall be recognized by the target corporation.

"(b) COST BASIS ACQUISITION.—

"(1) QUALIFIED STOCK ACQUISITIONS.—

"(A) GAIN OR LOSS RECOGNIZED AS IF SALE OF ASSETS.—For purposes of this subtitle, in the case of any qualified stock acquisition treated as a cost basis acquisition, the target corporation—

"(i) shall be treated as having sold all of its assets at the close of the acquisition date in a transaction in which gain or loss is recognized, and

"(ii) shall be treated as a new corporation which purchased all of the assets referred to in clause (i) as of the beginning of the day after the acquisition date.

"(B) PRICE AT WHICH DEEMED SALE MADE.—For purposes of subparagraph (A), the assets of the target corporation shall be treated as sold (and purchased) at an amount equal to the fair market value of such assets on the acquisition date.

"(C) ALLOCATION OF BASIS.—Except as provided in regulations, any adjustment to basis by reason of the deemed sale and purchase under subparagraph (A) shall be made on the basis of the relative fair market values of the assets treated as sold and purchased.

"(2) QUALIFIED ASSET ACQUISITIONS.—A qualified asset acquisition which is treated as a cost basis acquisition shall be treated as a sale or exchange of the assets of the target corporation in a transaction in which gain or loss is recognized.

"(3) SPECIAL RULE WHERE TARGET CORPORATION IN COST BASIS ACQUISITION IS MEMBER OF AFFILIATED GROUP.—For purposes of this subsection, in the case of any qualified stock acquisition or statutory merger or consolidation—

"(A) TARGET NOT TREATED AS MEMBER OF AFFILIATED GROUP.—Except as provided in this paragraph, or in regulations prescribed under this subparagraph, the target corporation in a cost basis acquisition shall not be treated as a member of an affiliated group with respect to the gain or loss recognized on such acquisition.

"(B) ELECTION TO BE TREATED AS MEMBER OF SELLING CONSOLIDATED GROUP.—Except as provided in regulations, in the case of a target corporation which (immediately before the acquisition date) was a member of the selling consolidated group, the acquiring corporation and the common parent of the selling consolidated group may elect to treat the target corporation as a member of the selling consolidated group with respect to the gain or loss recognized on such acquisition.

"(C) Combined deemed sale return.—Under regulations, a combined deemed sale return may be filed by all target corporations acquired by an acquiring corporation on the same acquisition date if such target corporations were members of the same selling consolidated group.

"(D) Selling consolidated group.—For purposes of this paragraph, the term 'selling consolidated group' means any group of corporations which (for the taxable year of the selling consolidated group which includes the acquisition date)—

"(i) includes the target corporation, and

"(ii) files a consolidated return.

"(4) Special rule for reverse triangular mergers.—In the case of a statutory merger which is treated as a qualified stock acquisition under section 364 (f), this subsection shall apply only to the assets held by the surviving corporation immediately before the acquisition.

### "SEC. 362. BASIS TO CORPORATIONS IN ORGANIZATIONS AND QUALIFIED ACQUISITIONS.

"(a) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If property was acquired by a corporation—

"(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

"(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

"(b) QUALIFIED ASSET ACQUISITIONS.—

"(1) BASIS OF PROPERTY ACQUIRED BY ACQUIRING CORPORATION IN CARRYOVER BASIS ASSET ACQUISITION.—If an acquiring corporation or any affiliated acquiring corporation acquires property from a target corporation in a qualified asset acquisition which is treated as a carryover basis acquisition, the basis of the property so acquired shall be equal to the basis of such property in the hands of the target corporation.

"(2) BASIS OF PROPERTY ACQUIRED BY TARGET CORPORATION.—The basis of any property (including qualifying consideration) received by a target corporation in a qualified asset acquisition shall be the fair market value of such property on the acquisition date.

"(c) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS TO CAPITAL.—

"(1) PROPERTY OTHER THAN MONEY.—Notwithstanding subsection (a)(2), if property other than money—

"(A) is acquired by a corporation as a contribution to capital, and

"(B) is not contributed by a shareholder as such,

then the basis of such property shall be zero.

"(2) MONEY.—Notwithstanding subsection (a)(2), if money—

"(A) is received by a corporation as a contribution to capital, and

"(B) is not contributed by a shareholder as such,

then, except as provided in regulations, the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations.

"(3) EXCEPTION FOR CONTRIBUTIONS IN AID OF CONSTRUCTION.—The provisions of this subsection shall not apply to contributions in aid of construction to which section 118(b) applies.

"(d) CROSS REFERENCES.—

**"(1) For purposes of determining the amount of gain recognized on receipt of a security in a transaction to which subsection (a) applies, see sections 351(b) and 453.**

**"(2) For basis of property acquired by acquiring or affiliated acquiring corporation in a cost basis qualified asset acquisition, see section 1012.**

**"(3) For basis of stock acquired by acquiring or affiliated acquiring corporation, see section 1020.**

## "Subpart D—Definitions and Special Rules

"Sec. 364. Qualified acquisitions.
"Sec. 365. Carryover basis and cost basis acquisitions defined.
"Sec. 366. Other definitions and special rules.
"Sec. 367. Foreign corporations.

### "SEC. 364. QUALIFIED ACQUISITIONS.

"(a) QUALIFIED ACQUISITION DEFINED.—For purposes of this part, the term 'qualified acquisition' means any qualified stock acquisition or any qualified asset acquisition.

"(b) QUALIFIED STOCK ACQUISITION DEFINED.—For purposes of this part, the term 'qualified stock acquisition' means any transaction or series of transactions during the

12-month acquisition period in which 1 corporation acquires stock representing control of another corporation.

"(c) QUALIFIED ASSET ACQUISITION DEFINED.—

"(1) IN GENERAL.—For purposes of this part, the term 'qualified asset acquisition' means—

"(A) any statutory merger or consolidation, or

"(B) except as provided in paragraph (2), any other transaction in which 1 corporation acquires at least—

"(i) 70 percent of the gross fair market value, and

"(ii) 90 percent of the net fair market value,

of the assets of another corporation held immediately before the acquisition of such assets.

"(2) TARGET CORPORATION MUST DISTRIBUTE ASSETS WITHIN 12-MONTHS.—A transaction described in paragraph (1)(B) shall not be treated as a qualified asset acquisition unless, within the 12 month period beginning on the acquisition date, the target corporation distributes all of its assets (other than assets retained to meet claims) to its shareholders and creditors.

"(3) CERTAIN DISTRIBUTIONS NOT TREATED AS QUALIFIED ASSET ACQUISITIONS.—Except as provided in regulations, a qualified asset acquisition shall not include a transaction in which a corporation acquires assets pursuant to a distribution (whether or not by liquidation).

"(d) ACQUIRING CORPORATION TREATED AS ACQUIRING STOCK HELD BY TARGET CORPORATION, ETC.—

"(1) IN GENERAL.—If, as a result of a qualified stock acquisition of 1 corporation, an acquiring corporation is treated under section 318(a) as owning stock of another corporation, the acquiring corporation shall be treated, for purposes of determining whether the acquiring corporation has made a qualified stock acquisition of such other corporation, as having acquired such stock of the other corporation on the acquisition date of such qualified stock acquisition.

"(2) SPECIAL RULES FOR APPLICATION OF SECTION 318(A).—For purposes of paragraph (1)—

"(A) CONTROL TREATED AS OWNERSHIP OF ALL STOCK.—In applying section 318(a)(2)(C), a controlling corporate shareholder of another corporation shall be treated as owning all of the stock of the other corporation.

"(B) OPTIONS DISREGARDED.—Section 318(a)(4) shall not apply.

"(e) SPECIAL RULES FOR ASSET ACQUISITION WHERE ASSETS INCLUDE STOCK OF ANOTHER CORPORATION.—

"(1) STOCK AND ASSET ACQUISITION TREATED SEPARATELY.—If—

"(A) an acquiring corporation acquires stock of another corporation in a qualified asset acquisition (determined by taking into account such stock), and

"(B) the acquisition of such stock is, or is part of, a qualified stock acquisition by the acquiring corporation,

then the acquiring corporation shall be treated as having acquired such stock of such other corporation in a qualified stock acquisition, and the assets (other than such stock) in a qualified asset acquisition, to which this part applies separately.

"(2) STOCK DISREGARDED IN CERTAIN ASSET ACQUISITIONS.—If—

"(A) an acquiring corporation acquires the assets of a target corporation in a qualified asset acquisition, and

"(B) another corporation owns stock of the target corporation, then such stock shall not be taken into account in determining whether the acquiring corporation has made a qualified asset acquisition of such other corporation.

"(f) REVERSE TRIANGULAR MERGERS TREATED AS STOCK ACQUISITIONS.—In the case of a statutory merger in which—

"(1) former shareholders of the surviving corporation sell or exchange stock in the surviving corporation, and

"(2) a corporation that was in control of the merged corporation before the merger is in control of the surviving corporation after the merger,

such merger shall, for purposes of this part, be treated as an acquisition of such stock of the former shareholders of the surviving corporation by the controlling corporation described in paragraph (2).

"(g) SPECIAL RULES FOR RECAPITALIZATIONS AND CHANGES IN IDENTITY, ETC.—For purposes of this part—

"(1) RECAPITALIZATIONS.—A recapitalization shall be treated as a qualified stock acquisition.

"(2) CHANGE IN IDENTITY, ETC.—A transaction which involves a mere change in identity, form, or place of organization of 1 corporation, however effected, shall be treated as a qualified asset acquisition.

"(h) SPECIAL RULES FOR TITLE 11 AND SIMILAR CASES.—In the case of a title 11 or similar case—

"(1) EXTENSION OF PERIOD TO DISTRIBUTE ASSETS.—The Secretary may extend the 12-month period under subsection (c)(2) in the case of a target corporation involved in such a case.

"(2) SUBSECTION (f) NOT TO APPLY.—Subsection (f) shall not apply if no former shareholders of the surviving corporation receive consideration in the merger in exchange for such shareholders' stock.

### "SEC. 365. CARRYOVER BASIS AND COST BASIS ACQUISITIONS DEFINED.

"(a) CARRYOVER BASIS ACQUISITION DEFINED.—For purposes of this part, the term 'carryover basis acquisition' means any qualified acquisition with respect to which no election under subsection (b) is made.

"(b) ELECTION TO BE TREATED AS COST BASIS ACQUISITION.—For purposes of this part—

"(1) IN GENERAL.—The term 'cost basis acquisition' means any qualified acquisition which the acquiring corporation elects to be treated as a cost basis acquisition.

"(2) TAXPAYER MAY ELECT CARRYOVER BASIS TREATMENT FOR CERTAIN UNAMORTIZABLE PROPERTY.—

"(A) IN GENERAL.—Subject to such terms and conditions as the Secretary may prescribe, any acquiring corporation may, notwithstanding paragraph (1) or subsection (c), elect to treat any unamortizable intangible as having been acquired in a carryover basis acquisition.

"(B) UNAMORTIZABLE INTANGIBLE.—For purposes of this paragraph, the term 'unamortizable intangible' means any intangible property which—

"(i) is of a character not subject to the allowance for depreciation under section 167 (or amortization in lieu thereof), and

"(ii) is—

"(I) goodwill, or

"(II) property of a type similar to goodwill and designated by the Secretary in regulations.

"(C) NO ELECTION WITH RESPECT TO INVENTORY, STOCK, ETC.—No election may be made under this paragraph with respect to property described in section 1031(a)(2) or 1221(1).

"(3) ELECTION ALSO TO BE MADE BY TARGET CORPORATION IN CERTAIN CASES.—In the case of a qualified asset acquisition other than a statutory merger or consolidation, any election under paragraph (1) or (2) shall not be effective unless such election is also made by the target corporation.

"(c) CONSISTENCY REQUIRED FOR ASSETS ACQUIRED DURING THE CONSISTENCY PERIOD.—

"(1) IN GENERAL.—Under regulations, if, in the case of a qualified acquisition—

"(A) an acquiring corporation acquires any asset during the consistency period, and

"(B) such asset and 1 or more other assets acquired in the qualified acquisition were held by the same corporation at any one time during the consistency period,

then such asset and all of the assets acquired in the qualified acquisition shall be treated as having been acquired in a cost basis acquisition.

"(2) EXCEPTIONS.—Paragraph (1) shall not apply—

"(A) ALL ASSETS TREATED AS CARRYOVER ASSETS.—If—

"(i) the asset described in paragraph (1)(A) was acquired in a qualified acquisition with respect to which an election under subsection (b)(1) was not made (or, except as provided in regulations, the acquiring corporation elects to treat such asset as so acquired), and

"(ii) an election under subsection (b)(1) was not made with respect to the qualified acquisition described in paragraph (1)(B).

"(B) ORDINARY COURSE OF BUSINESS.—If the asset described in paragraph (1)(A) is acquired pursuant to a sale by any person in the ordinary course of its trade or business.

"(C) REGULATIONS.—If the asset described in paragraph (1)(A) was acquired under circumstances described in regulations.

"(3) SPECIAL RULE FOR RELATED PARTY ACQUISITIONS.—If subsection (d) applies to any qualified acquisition described in paragraph (1)(B), then—

"(A) paragraph (1) shall not apply, and

"(B) except as provided in regulations, the asset described in paragraph (1)(A) shall be treated as having been acquired in such qualified acquisition.

"(4) QUALIFIED STOCK ACQUISITION TREATED AS ACQUISITION OF ASSETS.—For purposes of this subsection, an acquiring corporation in a qualified stock acquisition shall be treated as having acquired the assets of the target corporation.

"(5) ACQUISITION BY AFFILIATES OF THE ACQUIRING CORPORATION.—For purposes of this subsection, any acquisition during the consistency period by a member of any affiliated group of which the acquiring corporation is a member shall be treated as made by the acquiring corporation.

"(6) ASSET NOT TO INCLUDE STOCK WHICH IS PART OF QUALIFIED STOCK ACQUISITION.— For purposes of this subsection, the term 'asset' shall not include stock which is acquired as part of a qualified stock acquisition.

"(d) NO COST BASIS ELECTION IN RELATED PARTY ACQUISITIONS.—

"(1) IN GENERAL.—No election may be made under subsection (b) with respect to any qualified acquisition if 1 or more persons in control of the acquiring corporation immediately after the acquisition date were in control of the target corporation immediately before—

"(A) the acquisition date, or

"(B) in the case of a qualified stock acquisition, the 12-month acquisition period.

"(2) FAILURE TO DISTRIBUTE IN ASSET ACQUISITION.—If a transaction would be described in paragraph (1) but for the fact that the acquisition is not a qualified acquisition because the distribution requirements of section 364(c)(2) were not met, then, except as provided in regulations, such transaction shall, solely for purposes of determining the basis of the acquiring corporation (or any affiliated acquiring corporation) in any assets acquired, be treated as a qualified asset acquisition which is a carryover basis acquisition.

"(3) Definition of qualified acquisition.—For purposes of this subsection, the term 'qualified acquisition' shall have the same meaning as in section 364(a), except that the term 'substantially all' shall be substituted for clauses (i) and (ii) of section 364(c)(1)(B).

"(4) Control.—For purposes of paragraph (1)—

"(A) In general.—The term 'control' means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock.

"(B) Certain stock acquired from unrelated persons not taken into account.—

"(i) In general.—In the case of a qualified asset acquisition, for purposes of determining whether the acquiring corporation had control of the target corporation immediately before the acquisition date, stock acquired by the acquiring corporation from an unrelated person during the 12-month period preceding the acquisition date shall not be taken into account.

"(ii) UNRELATED PERSON.—A person is unrelated to an acquiring corporation at any time if—

"(I) neither such person or corporation owns, or is treated as owning under section 318(a), stock representing control of the other at such time, and

"(II) no other persons own, or are treated as owning under section 318(a), stock representing control of both such person and such corporation at such time.

For purposes of this clause, the term 'control' has the meaning given such term by subparagraph (A).

"(5) CONSTRUCTIVE OWNERSHIP.—

"(A) IN GENERAL.—Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this subsection.

"(B) MODIFICATIONS.—For purposes of subparagraph (A)—

"(i) paragraph (4) of section 318(a) shall not apply,

"(ii) paragraph (2)(C) and (3)(C) of section 318(a) shall be applied by substituting '5 percent' for '50 percent', and

"(iii) paragraph (3)(C) of section 318(a) shall be applied by considering a corporation as owning that portion of any stock (other than stock of such corporation) owned by or for any shareholder of such corporation which bears the same ratio to all such stock of such shareholder in such corporation as—

"(I) the value of stock which such shareholder owns or owned in such corporation, bears to

"(II) the value of all stock in such corporation.

"(e) NO ELECTION WITH RESPECT TO RECAPITALIZATIONS OR CHANGES IN IDENTITY, ETC.—No election may be made under subsection (b) with respect to any recapitalization or other transaction to which section 364(g) applies.

"(f) SPECIAL RULES FOR TAX-EXEMPT CORPORATIONS, FOREIGN CORPORATIONS, AND REGULATED INVESTMENT COMPANIES.—

"(1) IN GENERAL.—Except as provided in this subsection, in the case of a qualified asset acquisition to which this subsection applies—

"(A) the election under subsection (b) shall be treated as having been made with respect to such acquisition, and

"(B) subsection (d) shall not apply.

"(2) EXCEPTION FOR PROPERTY THE INCOME ON WHICH IS TAXABLE.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to any property described in paragraph (3)(D) or (4)(B)(i) of section 168(j).

"(B) SEPARATE TREATMENT.—Under regulations, property described in subparagraph (A) shall be treated as having been acquired in a separate acquisition.

"(3) ACQUISITIONS TO WHICH SUBSECTION APPLIES.—This subsection applies to any qualified asset acquisition with respect to which the acquiring corporation or affiliated acquiring corporation is—

"(A) exempt from tax imposed by this chapter,

"(B) a foreign corporation, or

"(C) a regulated investment company (determined under section 851 immediately after such acquisition).

This subsection shall not apply if the target corporation is the same type of corporation as the acquiring corporation or affiliated acquiring corporation.

"(g) ELECTION.—

"(1) WHEN MADE.—Any election under subsection (b) shall be made before the later of—

"(A) the 15th day of the 9th month following the month in which the acquisition date occurs, or

"(B) the date prescribed by the Secretary.

"(2) ELECTION IRREVOCABLE.—Any election under subsection (b), once made, shall be irrevocable.

"(3) NOTICE OF ELECTION.—Under regulations, any acquiring corporation which makes any election under subsection (b) with respect to a qualified stock acquisition shall provide notice of such election to any controlling corporate shareholder of the target corporation before the 12-month acquisition period from which stock was acquired.

**"SEC. 366. OTHER DEFINITIONS; SPECIAL RULES.**

"(a) IN GENERAL.—For purposes of this part—

"(1) 12-MONTH ACQUISITION PERIOD.—The term '12-month acquisition period' means, with respect to any qualified stock acquisition, the 12-month period beginning with the date of the first acquisition of stock included in the transaction or series of transactions involved in the qualified stock acquisition.

"(2) ACQUISITION DATE.—The term 'acquisition date' means, with respect to any target corporation—

"(A) in the case of a qualified stock acquisition, the first day on which there is a qualified stock acquisition of such target corporation, or

"(B) in the case of a qualified asset acquisition of the assets of a target corporation, the date on which the acquiring corporation acquires such assets.

"(3) AFFILIATED GROUP.—The term 'affiliated group' has the meaning given to such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)).

"(4) CONSISTENCY PERIOD.—

"(A) QUALIFIED STOCK ACQUISITIONS.—The term 'consistency period' means, with respect to any qualified stock acquisition, the period consisting of—

"(i) the 1-year period before the beginning of the 12-month acquisition period,

"(ii) that portion of the 12-month acquisition period ending with the acquisition date, and

"(iii) the 1-year period beginning on the day after the acquisition date.

"(B) QUALIFIED ASSET ACQUISITION.—The term 'consistency period' means, with respect to any qualified asset acquisition, the period consisting of—

"(i) the 1-year period ending on the day before the acquisition date,

"(ii) the acquisition date, and

"(iii) the 1-year period beginning on the day after the acquisition date.

"(5) ACQUISITIONS BY ACQUIRING CORPORATION INCLUDE ACQUISITIONS BY AFFILIATES.—Except as provided in regulations, an acquisition of stock or assets of a target corporation by more than 1 member of an affiliated group shall be treated as an acquisition by 1 corporation for—

"(A) purposes of determining whether there is a qualified acquisition to which this part applies, and

"(B) such other purposes of this part as may be specified in regulations.

"(b) ACQUIRING, TARGET, AND AFFILIATED ACQUIRING CORPORATION DEFINED.—For purposes of this part—

"(1) ACQUIRING CORPORATION.—

"(A) IN GENERAL.—The term 'acquiring corporation' means any corporation which makes a qualified acquisition of another corporation.

"(B) SPECIAL RULE FOR MEMBERS OF AFFILIATED GROUP.—

"(i) IN GENERAL.—Except as provided in regulations or clause (ii), in any case to which subsection (a)(5) applies, the acquiring corporation shall be the common parent of the affiliated group.

"(ii) EXCEPTION WHERE 1 CORPORATION MAKES QUALIFIED ACQUISITION.—In any case to which subsection (a)(5) applies and in which 1 member of the affiliated group other than the common parent has made a qualified acquisition of the target corporation (determined without regard to any acquisitions by other members of such group), the acquiring corporation shall be such member of the affiliated group.

"(2) TARGET CORPORATION.—The term 'target corporation' means any corporation the stock or assets of which are acquired in a qualified acquisition.

"(3) AFFILIATED ACQUIRING CORPORATION.—The term 'affiliated acquiring corporation' means any corporation which is a member of an affiliated group and which—

"(A) acquired stock or assets in a qualified acquisition, but

"(B) is not treated as the acquiring corporation.

"(4) COMMON PARENT.—The term 'common parent' has the same meaning given such term by section 1504(a) (without regard to section 1504(b)).

"(c) CONTROL.—For purposes of this part, the term 'control' means the ownership of stock in a corporation which meets the requirements of paragraph (2) of section 1504(a).

"(d) PARTY TO THE ACQUISITION.—For purposes of this part, the term 'party to the acquisition' means, with respect to any qualified acquisition—

"(1) the acquiring corporation, and

"(2) in the case of an acquiring corporation which is a member of an affiliated group, the common parent of such group and any other member of such group specified in regulations.

"(e) REGULATIONS RELATING TO REVERSE ACQUISITIONS.—The Secretary shall provide regulations consistent with the purposes of this part for the application of this title to any qualified acquisition after which shareholders of the target corporation own, as a result of owning stock in the target corporation, stock representing control of the acquiring corporation. For purposes of the preceding sentence, in determining whether shareholders own stock representing control, section 1504(a)(2) shall be applied by substituting '50 percent' for '80 percent' each place it appears.

"(f) QUALIFYING AND NONQUALIFYING CONSIDERATION.—For purposes of this part—

"(1) QUALIFYING CONSIDERATION.—The term 'qualifying consideration' means property which is received in an exchange without recognition of gain by reason of section 351, 354, 355, 356, or 361, whichever is appropriate.

"(2) NONQUALIFYING CONSIDERATION.—

"(A) IN GENERAL.—The term 'nonqualifying consideration' means property (including money) received in an exchange to which section 351, 354, 355, 356, or 361 applies, whichever is appropriate, other than qualifying consideration.

"(B) SECURITIES.—In any case in which securities are received in an exchange described in subparagraph (A), the term 'nonqualifying consideration' includes the excess of the issue price of such securities over the adjusted basis of any securities surrendered in such exchange.

"(g) CONTROLLING CORPORATE SHAREHOLDER.—For purposes of this part, the term 'controlling corporate shareholder' means a corporation which owns stock representing control of another corporation.

"(h) TITLE 11 OR SIMILAR CASE.—For purposes of this part, the term 'title 11 or similar case' means—

"(1) a case under title 11 of the United States Code, or

"(2) a receivership, foreclosure, or similar proceeding in a Federal or State court.

"(i) FAIR MARKET VALUE OF SECURITIES.—For purposes of this part, the fair market value of any security shall be equal to its issue price (as determined under section 1273(b) and 1274(a)).

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including (but not limited to) regulations—

"(1) which treat warrants, obligations convertible into stock, and other similar interests as stock and stock as not stock, and

"(2) which treat options to acquire or sell stock as having been exercised.

**"SEC. 367. FOREIGN CORPORATIONS.**

"(a) Transfers of Property From the United States.—

"(1) General rule.—If, in connection with any exchange described in section 332, 351, 354, 356, or 361(a), a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

"(2) Exception for certain stock or securities.—Except to the extent provided in regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporaton which is a party to the exchange or a party to the acquisition.

"(3) Exception for transfers of certain property used in the active conduct of a trade or business.—

"(A) In general.—Except as provided in regulations, paragraph (1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.

"(B) PARAGRAPH NOT TO APPLY TO CERTAIN PROPERTY.—Except as provided in regulations, subparagraph (A) shall not apply to any—

"(i) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.),

"(ii) installment obligations, accounts receivable, or similar property,

"(iii) foreign currency or other property denominated in foreign currency,

"(iv) intangible property (within the meaning of section 936(h)(3)(B)), or

"(v) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.

"(C) TRANSFER OF FOREIGN BRANCH WITH PREVIOUSLY DEDUCTED LOSSES.—Except as provided in regulations, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that—

"(i) the sum of losses—

"(I) which were incurred by the foreign branch before the transfer, and

"(II) with respect to which a deduction was allowed to the taxpayer,

exceeds

"(ii) the sum of—

"(I) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and

"(II) the amount which is recognized under section 904(f)(3) on account of the transfer.

Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside the United States having the same character as such losses had.

"(4) SPECIAL RULE FOR TRANSFER OF PARTNERSHIP INTERESTS.—Except as provided in regulations, a transfer by a United States person of an interest in a partnership to a foreign corporation in an exchange described in paragraph (1) shall, for purposes of this subsection, be treated as a transfer to such corporation of such person's pro rata share of the assets of the partnership.

"(5) SECRETARY MAY EXEMPT CERTAIN TRANSACTIONS FROM APPLICATIONS OF THIS SUBSECTION.—Paragraph (1) shall not apply to the transfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation.

"(b) OTHER TRANSFERS.—

"(1) EFFECT OF SECTION TO BE DETERMINED UNDER REGULATIONS.—In the case of any exchange described in section 332, 351, 354, 355, 356, or 361(a) in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

"(2) REGULATIONS RELATING TO SALE OR EXCHANGE OF STOCK IN FOREIGN CORPORATIONS.—The regulations prescribed pursuant to paragraph (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing—

"(A) the circumstances under which—

"(i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or

"(ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and

"(B) the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.

"(c) TRANSACTIONS TO BE TREATED AS EXCHANGES.—

"(1) SECTION 355 DISTRIBUTION.—For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

"(2) CONTRIBUTION OF CAPITAL TO CONTROLLED CORPORATIONS.—For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporaton equal in value to the fair market value of the property transferred.

"(d) SPECIAL RULES RELATING TO TRANSFERS OF INTANGIBLES.—

"(1) IN GENERAL.—Except as provided in regulations, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361(a)—

"(A) subsection (a) shall not apply to the transfer of such property, and

"(B) the provisions of this subsection shall apply to such transfer.

"(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO SALE OF CONTINGENT PAYMENTS.—

"(A) IN GENERAL.—If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

"(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

"(ii) receiving amounts which reasonably reflect the amounts which would have been received—

"(I) annually in the form of such payments over the useful life of such property, or

"(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

"(B) EFFECT ON EARNINGS AND PROFITS.—For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under subparagraph (A)(ii).

"(C) AMOUNTS RECEIVED TREATED AS UNITED STATES SOURCE ORDINARY INCOME.—For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States.

"(e) TRANSITIONAL RULE.—In the case of any exchange beginning before January 1, 1978—

"(1) subsection (a) shall be applied without regard to whether or not there is a transfer of property described in subsection (a)(1), and

"(2) subsection (b) shall not apply.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions occurring after December 31, 1985, in taxable years ending after such date.

## SUBTITLE B—CORPORATE DISTRIBUTIONS

### SEC. 111. CORPORATE RECOGNITION OF GAIN OR LOSS ON DISTRIBUTIONS OF PROPERTY BY CORPORATIONS.

(a) DISTRIBUTIONS OF PROPERTY WITH RESPECT TO STOCK.—Section 311 (relating to taxability of corporation on distribution) is amended to read as follows:

### "SEC. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

"(a) RECOGNITION OF GAIN OR LOSS.—Except as provided in this section—

"(1) RECOGNITION OF GAIN.—Gain shall be recognized to a corporation on the distribution of property with respect to its stock.

"(2) LOSS RECOGNIZED ONLY IN CASE OF COMPLETE LIQUIDATION.—Loss shall be recognized to a corporation on the distribution of property with respect to its stock only if such distribution is pursuant to a plan of complete liquidation.

"(3) DETERMINATION OF GAIN OR LOSS.—Gain or loss under this subsection shall be determined in the same manner as if the property distributed had been sold to the distributee at its fair market value.

"(b) EXCEPTION FOR DISTRIBUTIONS WHERE BASIS DETERMINED UNDER SECTION 334(b).—Subsection (a) shall not apply to any distribution of property if the distributee's basis in such property is determined under section 334(b).

"(c) SECTION 355 TRANSACTIONS.—Gain or loss shall not be recognized with respect to any distribution of stock of a controlled corporation in a transaction to which section 355 applies.

"(d) DISTRIBUTION OF STOCK OF CONTROLLED SUBSIDIARY.—Subsection (a) shall not apply to the distribution by a corporation of stock of another corporation if—

"(1) during the 5-year period immediately preceding the date of such distribution such corporation owns stock representing control of the other corporation, and

"(2) within such 5-year period such other corporation has not received from the distributing corporation property constituting a substantial part of its assets in a transaction to which section 351 applies or as a contribution to capital.".

(b) EFFECTIVE DATES.—The amendments made by this section apply to distributions made after December 31, 1985, in taxable years ending after such date.

## SUBTITLE C—CORPORATE LIQUIDATIONS

### SEC. 121. REPEAL OF SECTIONS 336, 337, 338, AND 341.

The following sections are hereby repealed:

(1) Section 336 (relating to distributions of property in liquidation).

(2) Section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations).

(3) Section 338 (relating to certain stock acquisitions treated as asset acquisitions).

(4) Section 341 (relating to collapsible corporations).

### SEC. 122. MODIFICATION OF SECTION 333 ELECTION.

Section 333 (relating to election as to recognition of gain in certain liquidations) is amended to read as follows:

### "SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

"(a) GENERAL RULE.—In the case of a complete liquidation of any domestic corporation, gain on the stock held by any qualified electing shareholder (as defined in subsection (b)) shall be recognized only to the extent of the money or property described in subparagraphs (B) through (E) of section 1031(a)(2) received by such shareholder in such liquidation.

"(b) QUALIFIED ELECTING SHAREHOLDER.—For purposes of this section, the term 'qualified electing shareholder' means any shareholder of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and who—

"(1) elects to have this section apply; and

"(2) in the case of an eligible shareholder to whom section 1060 applies, elects not to have the provisions of section 1060 apply to such stock.".

**SEC. 123. EFFECTIVE DATES.**

(a) SECTIONS 333, 336, AND 337.—The amendments made by paragraphs (1) and (2) of section 121 and section 122 shall apply to liquidations made pursuant to plans of liquidation adopted after December 31, 1985.

(b) SECTION 338.—The amendment made by paragraph (3) of section 121 shall apply to acquisitions made after December 31, 1985, except that such amendment shall not apply to qualified stock purchases (as defined in section 338(d)(3) of the Internal Revenue Code of 1954) where the acquisition date (as defined in section 338(h)(2) of such Code) is before January 1, 1987.

(c) SECTION 341.—The amendment made by paragraph (4) of section 121 shall apply to sales, exchanges, and distributions made after December 31, 1985.

## SUBTITLE D—TECHNICAL AND CONFORMING CHANGES

### SEC. 131. TECHNICAL AND CONFORMING CHANGES.

(a) AMENDMENTS RELATED TO SECTION 311.—

(1) Paragraph (1) of section 267(a) (relating to disallowance of losses in transactions between related parties) is amended—

(A) by striking out "(other than losses in cases of distributions in corporate liquidations)", and

(B) by inserting ", except that this paragraph shall not apply to any loss of an individual in an exchange of stock of the individual for property of a corporation pursuant to a plan of complete liquidation of such corporation" before the period at the end thereof.

(2) Section 301(e) (relating to special rule for holding period of appreciated property distributed to corporation) is amended—

(A) by striking out "paragraph (1) of section 311(d)" in paragraphs (1)(B) and (2)(B) and inserting in lieu thereof "section 311(a)", and

(B) by striking out "SECTION 311(d)" in the headings of paragraphs (1) and (2) and inserting in lieu thereof "SECTION 311(a)".

(3)(A) Subsection (n) of section 312 (relating to adjustments to earnings and profits) is amended by striking out paragraph (4) and by redesignating paragraphs (5), (6), (7), (8), and (9) as paragraphs (4), (5), (6), (7), and (8), respectively.

(B) Paragraph (8) of section 312(n) (as redesignated by subparagraph (A)) is amended by striking out "paragraphs (5), (6), and (7)" and inserting in lieu thereof "paragraphs (4), (5), and (6)".

(4) Section 995(c)(1)(C) (relating to gain on disposition of stock of a DISC) is amended by striking out "in a transaction to which section 311, 336, or 337 applies" and inserting in lieu thereof "in a transaction to which section 311 does not apply by reason of subsection (b), (c), or (d) thereof".

(b) AMENDMENT RELATED TO SECTION 332.—Paragraph (1) of section 332(b) (relating to liquidations to which section applies) is amended to read as follows:

"(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either".

(c) AMENDMENTS RELATED TO SECTION 336.—

(1) Paragraph (4) of section 312(n) (relating to LIFO inventory adjustments), as redesignated by subsection (a)(2), is amended to read as follows:

"(4) LIFO INVENTORY ADJUSTMENTS.—

"(A) IN GENERAL.—Earnings and profits shall be increased or decreased by the amount of any increase or decrease in the LIFO recapture amount as of the close of each taxable year; except that any decrease below the LIFO recapture amount as of the close of the taxable year preceding the first taxable year to which this paragraph applies to the taxpayer shall be taken into account only to the extent provided in regulations.

"(B) LIFO RECAPTURE AMOUNT.—For purposes of this subsection, the term 'LIFO recapture amount' means the amount (if any) by which—

"(i) the inventory amount of the inventory assets under the first-in, first-out method authorized by section 471, exceeds

"(ii) the inventory amount of such assets under the LIFO method.

"(C) DEFINITIONS.—For purposes of this subsection—

"(i) LIFO METHOD.—The term 'LIFO method' means the method authorized by section 472 (relating to last-in, first-out inventories).

"(ii) INVENTORY ASSETS.—The term 'inventory assets' means stock in trade of the corporation, or other property of a kind which would be properly included in the inventory of the corporation if on hand at the close of the taxable year.

"(iii) INVENTORY AMOUNT.—The term 'inventory amount' means, in the case of inventory assets distributed during a year, the amount of such inventory assets determined—

"(I) as if the taxable year closed at the time of such distribution, and

"(II) under the retail method under section 472, or if such method is not applicable, by using the lower of cost or market.".

(2) Section 897(d) (relating to treatment of distributions, etc. by foreign corporations) is amended to read as follows:

"(1) IN GENERAL.—Except to the extent otherwise provided in regulations, notwithstanding any other provision of this chapter, gain shall be recognized by a foreign corporation on the distribution (including a distribution in liquidation or redemption) of a United States real property interest in an amount equal to the excess of the fair market value of such interest (as of the time of the distribution) over its adjusted basis.

"(2) EXCEPTIONS.—Gain shall not be recognized under paragraph (1)—

"(A) if—

"(i) at the time of the receipt of the distributed property, the distributee would be subject to taxation under this chapter on a subsequent disposition of the distributed property, and

"(ii) the basis of the distributed property in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation, or

"(B) if such nonrecognition is provided in regulations under subsection (e)(2).".

(3) Section 897 is amended by striking out subsection (l) (relating to special rule for certain United States shareholders of liquidating corporations).

(4) Section 1248(f) (relating to certain section 311, 336, or 337 transactions) is amended—

(A) by striking out ", 336, or 337 applies" in paragraph (1)(B) and inserting in lieu thereof "does not apply by reason of subsection (b), (c), or (d) thereof", and

(B) by striking out ", 336, OR 337" in the heading thereof.

(5) Paragraph (2) of section 6038B(a) (relating to notice of certain transfers to foreign persons) is amended to read as follows:

"(2) makes a distribution in complete liquidation to a person who is not a United States person,".

(d) AMENDMENTS RELATED TO SECTION 337.—

(1) Section 346(b) (relating to transactions which might reach same result as partial liquidations) is amended by striking out "337,".

(2)(A) Subparagraphs (A) and (B) of section 453(h)(1) (relating to use of installment sales in section 337 liquidations) are amended to read as follows:

"(A) IN GENERAL.—If, in a liquidation to which section 331 applies, the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

"(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.—Subparagraph (A) shall not apply to an installment obligation acquired in respect of a sale or exchange of—

"(i) stock in trade of the corporation,

"(ii) other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and

"(iii) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

unless such property is attributable to a trade or business and is sold or exchanged to one person in one transaction.".

(B) Subparagraph (E) of section 453(h)(1) is amended to read as follows:

"(E) SALES BY LIQUIDATING SUBSIDIARIES.—For purposes of subparagraph (A), in the case of a controlling corporate shareholder (within the meaning of section 366(g)) of a selling corporation, an obligation acquired in respect of a sale or exchange by the selling corporation shall be treated as so acquired by such controlling corporate shareholder. The preceding sentence shall be applied successively to each controlling corporate shareholder above such controlling corporate shareholder.".

(C) The heading for section 453(h) is amended by striking out "SECTION 337" and inserting in lieu thereof "CERTAIN".

(3) Section 453B(d) (relating to effect of distribution in certain liquidations) is amended to read as follows:

"(d) LIQUIDATIONS TO WHICH SECTION 332 APPLIES.—If—

"(1) an installment obligation is distributed in a liquidation to which section 332 (relating to complete liquidations of subsidiaries) applies, and

"(2) the basis of such obligation in the hands of a distributee is determined under section 334(b)(1),

then no gain or loss with respect to the distribution of such obligation shall be recognized by the distributing corporation.".

(4) Section 1056(a) (relating to basis limitation for player contracts) is amended by striking out the last sentence.

(5) Section 1248(d) (relating to exclusion from earnings and profits) is amended by striking out paragraph (2).

(e) AMENDMENTS RELATED TO SECTION 338.—

(1) Section 168(e)(4)(E) (relating to liquidation of a subsidiary) is amended by striking out the last sentence.

(2) Section 269 (relating to acquisitions made to evade or avoid tax) is amended—

(A) by striking out subsection (b) and redesignating subsection (c) as subsection (b), and

(B) by striking out "or (b)" in subsection (b), as so redesignated.

(3) Section 318(b) (relating to cross references) is amended by striking out paragraph (4) and by redesignating paragraphs (5), (6), (7), and (8) as paragraphs (4), (5), (6), and (7), respectively.

(4) Subparagraph (B) of section 617(h)(3) (relating to limitation) is amended by striking out "338,".

(5) Paragraph (6) of section 1362(e) is amended by striking out subparagraph (C) and by redesignating subparagraph (D) as subparagraph (C).

(f) AMENDMENTS RELATED TO SECTION 341.—

(1) Subparagraph (C) of section 467(c)(5) (relating to special rules) is amended by striking out "341(e)(12), 453B(d)(2),".

(2) Paragraph (2) of section 1255(b) (relating to special rules) is amended by striking out "341(e)(12), 453B(d)(2),".

(g) AMENDMENT RELATED TO SECTION 356.—Section 1248(g) (relating to exceptions) is amended by inserting "or" at the end of paragraph (1), by striking out paragraph (2), and by redesignating paragraph (3) as paragraph (2).

(h) AMENDMENTS RELATED TO SECTION 361.—Each of the following provisions are amended by striking out "361" each place it appears and inserting in lieu thereof "361(a)":

(1) Section 58(g).

(2) Section 168(e)(4)(C).

(3) Section 168(f)(10)(B)(i).

(4) Section 332(b).

(5) Section 381(a).

(6) Section 1245(b)(3).

(7) Section 1250(d)(3).

(8) Section 6038B(a).

(i) AMENDMENTS RELATED TO SECTION 368.—

(1) Each of the following provisions are amended by striking out "section 368(c)" each place it appears and inserting in lieu thereof "section 366(c)":

(A) Section 108(e)(7)(D).

(B) Section 249(b)(2).

(C) Section 279(e).

(D) Section 512(b)(13).

(2) Subparagraph (D) of section 247(b)(2) (relating to issuance of stock) is amended by striking out "reorganization (as defined in section 368(a))" and inserting in lieu thereof "qualified acquisition which is treated as

carryover basis acquisition (within the meaning of part III of subchapter C of this chapter)".

(3) Section 306(c)(1)(B) (relating to stock received in a corporate reorganization or separation) is amended—

(A) by striking out "in pursuance of a plan of reorganization (within the meaning of section 368(a)), or" in clause (i),

(B) by inserting "section 354 or" before "section 355" each place it appears in clause (i), and

(C) by striking out "REORGANIZATION" in the heading and inserting in lieu thereof "ACQUISITION".

(4) Section 312(h)(2) (relating to allocation of earnings and profits in certain corporate separations and reorganizations) is amended to read as follows:

"(2) CERTAIN CORPORATE ACQUISITIONS.—The Secretary shall by regulations provide for the allocation of earnings and profits in—

"(A) a qualified asset acquisition where the acquiring corporation does not acquire all the assets of the target corporation, "(B) any cost basis acquisition with respect to which an election under section 365(b)(2) is made, and

"(C) any acquisition to which section 364(e) applies.".

(5)(A) Paragraph (2) of section 381(a) (relating to carryovers in certain acquisitions) is amended to read as follows:

"(2) in a transfer to which section 361(a) (relating to nonrecognition of gain or loss to corporations in a carryover basis acquisition) applies,".

(B) Section 381(a) is amended by striking out the last sentence.

(C) Section 381(b) is amended by striking out "a reorganization described in subparagraph (F) of section 368(a)(1)" and inserting in lieu thereof "a qualified acquisition described in section 364(g)(2)".

(6) Paragraph (9) of section 542(c) (relating to exceptions) is amended by striking out "section 368(a)(3)(A)" and inserting in lieu thereof "section 366(h)".

(7) Section 995(e) (relating to certain transfers of DISC assets) is amended by striking out "a reorganization within the meaning of section 368" and inserting in lieu thereof "a qualified acquisition which is a

carryover basis acquisition (within the meaning of part III of subchapter C of this chapter)".

(8) Subparagraphs (A) and (B) of section 1101(c)(1) are each amended by inserting "(as in effect before the Subchapter C Revision Act of 1985)" after "section 368(a)(1)(A), (B), (E), or (F)".

(9) Subparagraph (D) of section 1101(c)(1) is amended by inserting "(as in effect before the Subchapter C Revision Act of 1985)" after "section 368(a)(1)(A) or (B)".

(10) Paragraph (3) of section 1103(b) (defining qualified bank holding corporation) is amended by striking out "a reorganization described in section 368(a)(1)(F)" and inserting in lieu thereof "a qualified acquisition described in section 364(g)(2)".

(11) Section 1244(d)(2) (relating to recapitalizations) is amended by striking out "a reorganization described in section 368(a)(1)(F)" each place it appears and inserting in lieu thereof "a qualified acquisition described in section 364(g)(2)".

(12) Section 1275(a)(4) (relating to special rule for determination of issue price in reorganizations) is amended—

(A) by striking out "issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1))" in subparagraph (A)(i),

(B) by inserting "in a transaction in which no gain or loss is recognized on such exchange under section 354" before ", and" in subparagraph (A)(i), and

(C) by striking out "IN REORGANIZATIONS" in the heading and inserting in lieu thereof "IN CERTAIN NONRECOGNITION TRANSACTIONS".

(13) Paragraph (2) of section 4978(d) (relating to certain reorganizations) is amended—

(A) by striking out "reorganization described in section 368(a)(1)" and inserting in lieu thereof "qualified acquisition which is a carryover basis acquisition (within the meaning of part III of subchapter C of chapter 1)", and

(B) by striking out "REORGANIZATIONS" and inserting in lieu thereof "ACQUISITIONS".

(14) Subparagraph (C) of section 6166(g)(1) (relating to excelleration of payment) is amended by striking out "a plan of reorganization described in subparagraph (D), (E), or (F) of section 368(a)(1)" and inserting in lieu thereof "a qualified acquisition described in section 364(g) or 365(d)".

(15) Paragraph (2) of section 6901(a) (relating to other taxes) is amended by striking out "a reorganization within the meaning of section 368(a)" and inserting in lieu thereof "a qualified acquisition which is a carryover basis acquisition (within the meaning of part III of subchapter C of chapter 1)".

(j) AMENDMENTS RELATED TO INSOLVENCY REORGANIZATIONS.—

(1)(A) Subchapter C of chapter 1 is amended by striking out part IV.

(B) The table of parts for subchapter C of chapter 1 is amended by striking out the item relating to part IV.

(2) Section 47(b) is amended by inserting "or" at the end of paragraph (1), by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period, and by striking out paragraph (3).

(3) Subparagraph (C) of section 168(e)(4) is amended by striking out "371(a), 374(a),".

(4) Section 247(b)(2)(D) is amended by striking out ", a transaction to which section 371 (relating to insolvency reorganizations) apply,".

(5) Section 250(c)(1) is amended by striking out "374 or".

(6) Section 617(h)(3)(B) is amended by striking out "372(a), 374(b)(1),".

(7) Section 1245(b)(3) is amended by striking out "371(a), 374(a),".

(8) Section 1250(d)(3) is amended by striking out "371(a), 374(a),".

(k) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions occurring after December 31, 1985.

# TITLE II—PROVISIONS RELATING TO GAIN AND LOSS OF SHAREHOLDERS OF CORPORATIONS

## Subtitle A—Basis Adjustments

### SEC. 201. BASIS OF CONTROLLING CORPORATE SHAREHOLDER IN SUBSIDIARY.

(a) IN GENERAL.—Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by inserting after section 1019 the following new section:

### "SEC 1020. BASIS OF CONTROLLING CORPORATE SHAREHOLDER IN SUBSIDIARY.

"(a) GENERAL RULE.—The basis of any controlling corporate shareholder at any time in the stock of a controlled corporation shall be equal to the applicable percentage of the net inside basis of such controlled corporation—

"(1) increased by the balance of the premium account as of such time, and

"(2) reduced by the balance of the discount account as of such time.

"(b) ALLOCATION OF BASIS UPON DISPOSITION OF STOCK.—

"(1) IN GENERAL.—If a controlling corporate shareholder disposes of any stock of a controlled corporation, the basis determined under subsection (a) shall be allocated to such stock in an amount which bears the same ratio to such basis as the—

"(A) value of the stock disposed of, bears to

"(B) the value of all stock held by the controlling corporate shareholder immediately before the disposition.

"(2) SPECIAL RULE WHERE SHAREHOLDER NOT IN CONTROL AFTER DISPOSITION.—If a controlling corporate shareholder disposes of stock of the controlled corporation and after such disposition, the controlling corporate shareholder is not in control of the controlled corporation, then—

"(A) the controlling corporate shareholder's basis in the stock of the controlled corporation shall be equal to that portion of the basis not allocated to the disposed stock under paragraph (1), and

"(B) the balance in the premium and discount accounts with respect to such stock on and after the date of disposition shall be treated as zero.

The Secretary may by regulations provide that this paragraph shall not apply in the case of any disposition a primary purpose of which is the avoidance of Federal income tax.

"(c) NET INSIDE BASIS DEFINED.—For purposes of this section, the net inside basis of any controlled corporation shall be equal to—

"(1) the aggregate adjusted basis of the assets held by such corporation, reduced by,

"(2) the aggregate adjusted issue prices of any outstanding liabilities (other than liabilities described in section 357(b)(2)(B)) of such corporation.

"(d) PREMIUM AND DISCOUNT ACCOUNTS.—For purposes of this section—

"(1) IN GENERAL.—If—

"(A) a controlling corporate shareholder's basis in the controlled corporation as of the control date (determined without regard to this section) is greater or less than—

"(B) the applicable percentage of the net inside basis of the controlled corporation as of the control date,

the controlling corporate shareholder shall establish a premium or discount account, as the case may be, with respect to the controlled corporation.

"(2) OPENING BALANCE.—The opening balance of a premium or discount account shall be the amount by which the amount determined under paragraph (1)(A) is greater or less, respectively, than the amount determined under paragraph (1)(B).

"(3) ACCOUNTS ADJUSTED FOR GAIN RECOGNIZED BY CONTROLLED CORPORATION.—

"(A) IN GENERAL.—A discount account shall be increased and a premium account decreased by the applicable percentage of any gain recognized by the controlled corporation on the disposition of its assets.

"(B) EXCEPTION FOR APPRECIATION AFTER CONTROL DATE.—Subparagraph (A) shall not apply to any gain which the controlling corporate shareholder establishes is allocable to periods after the control date.

"(C) REDUCTION IN PREMIUM ACCOUNT BELOW ZERO.—If any reduction in the premium account under subparagraph (A) would reduce such account below zero, the controlling corporate shareholder shall establish a discount account and credit such account with the amount of the reduction below zero.

"(4) ACCOUNTS ADJUSTED FOR LOSSES RECOGNIZED BY CONTROLLED CORPORATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a discount account shall be reduced (but not below zero) by the applicable percentage of any loss recognized by the controlled corporation on the dispositon of its assets.

"(B) LOSSES ALLOCABLE TO PRE-CONTROL DATE PERIODS.—If a controlling corporate shareholder establishes that any portion of the loss described in subparagraph (A) is allocable to periods before the control date, then

"(i) in the case of a discount account, such account shall—

"(I) first be reduced (but not below zero) by the portion of such loss not so allocable, and

"(II) then be reduced by the portion of such loss so allocable, except that if such reduction would reduce the discount account below zero, the controlling corporate shareholder shall establish a premium account and credit such account with the amount of the reduction below zero, and

"(ii) in the case of a premium account, such account shall be increased by the portion of the loss so allocable.

"(5) NO ACCOUNTS AFTER 3RD TAXABLE YEAR.—In the case of any taxable year after the 3rd taxable year beginning after the control date, the balance in any premium or discount account shall be zero and no other adjustments shall be made to such account.

"(6) SPECIAL RULE FOR COST BASIS QUALIFIED STOCK ACQUISITION.—In the case of a qualified stock acquisition with respect to which an election was made under section 365(b)(1), no premium or discount account shall be established and no adjustments shall be made under paragraph (1) or (2) of subsection (a).

"(7) CONTROL DATE.—For purposes of this subsection, the term 'control date' means—

"(A) in the case of a qualified stock acquisition, the acquisition date (within the meaning of section 366(a)(2)), and

"(B) in any other case, the later of—

"(i) the date on which the controlling corporate shareholder acquires control of the controlled corporation, or

"(ii) January 1, 1986.

"(e) CONTROLLING CORPORATE SHAREHOLDER, CONTROLLED CORPORATION, APPLICABLE PERCENTAGE, AND STOCK DEFINED.—For purposes of this section.—

"(1) CONTROLLING CORPORATE SHAREHOLDER.—

"(A) IN GENERAL.—The term 'controlling corporate shareholder' means any corporation which owns stock representing control (within the meaning of section 366(c)) of another corporation.

"(B) SPECIAL RULES FOR MEMBERS OF AFFILIATED GROUPS.—In any case where more than 1 member of an affiliated group (within the meaning of section 366(a)(3)) owns stock in another corporation—

"(i) all such stock shall be treated as owned by 1 member of such group for purposes of subparagraph (A), and

"(ii) if the members of such group own stock representing control of such other corporation, each member owning such stock shall be treated as a controlling corporate shareholder.

"(2) CONTROLLED CORPORATION.—The term 'controlled corporation' means any corporation with respect to which another corporation owns stock representing control of such corporation.

"(3) APPLICABLE PERCENTAGE.—For purposes of this subsection, the term 'applicable percentage' means the percentage of stock (by value) of the controlled corporation held by the controlling corporate shareholder.

"(4) STOCK.—For purposes of this section, the term 'stock' does not include any stock described in section 1504(a)(4).".

(b) CONFORMING AMENDMENT.—The table of sections for part II of subchapter O of chapter 1 is amended by adding after section 1019 the following new item:

"Sec. 1020. Basis of controlling corporate shareholder in subsidiary.".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1986.

### SEC. 202. BASIS ADJUSTMENTS TO REFLECT CORPORATE LEVEL TAX PAID IN CERTAIN CORPORATE ACQUISITIONS AND LIQUIDATIONS.

(a) IN GENERAL.—Part IV of subchapter O of chapter 1 (relating to special rules for gain and loss on dispositions of property) is amended by redesignating section 1060 as section 1061 and by inserting after section 1059 the following new section:

### "SEC. 1060. INCREASE IN BASIS OF ELIGIBLE SHAREHOLDER'S STOCK TO REFLECT CORPORATE LEVEL TAX PAID IN CERTAIN ACQUISITIONS AND LIQUIDATIONS OF SMALL BUSINESS CORPORATIONS.

"(a) GENERAL RULE.—In the case of any section 1060 transaction involving any corporation, the basis of an eligible shareholder's stock in such corporation shall be increased by the lesser of—

"(1) such shareholder's pro rata share of the aggregate basis adjustment, or

"(2) the excess of—

"(A) the fair market value of such stock immediately before such increase, over

"(B) the adjusted basis of such stock at such time.

"(b) AGGREGATE BASIS ADJUSTMENT.—For purposes of this section—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'aggregate basis adjustment' means, with respect to any section 1060 transaction, the excess of—

"(A) an amount equal to—

"(i) the long-held capital asset tax, divided by

"(ii) 0.28, over

"(B) the long-held capital asset tax.

"(2) PHASE-OUT FOR CORPORATIONS WITH FAIR MARKET VALUE IN EXCESS OF $1,000,000.—

"(A) IN GENERAL.—The aggregate basis adjustment shall be reduced (but not below zero) by 10 percent for each $100,000 by which the value of the stock (including stock described in section 1504(a)(4)) of the applicable corporation on the transaction date exceeds $1,000,000.

"(B) CERTAIN TRANSACTIONS DISREGARDED.—The Secretary may by regulation provide that the disposition of stock or assets or any other transaction be disregarded if the primary purpose of such transaction is to avoid the limitation under subparagraph (A).

"(3) LONG-HELD CAPITAL ASSET TAX.—

"(A) IN GENERAL.—The term 'long-held capital asset tax' means the excess (if any) of—

"(i) the sum of the taxes imposed by this chapter on—

"(I) the applicable corporation, and

"(II) any qualified subsidiary of the applicable corporation,

for each taxable year which includes the disposition period, over

"(ii) the sum of such taxes determined without regard to any gain or loss on the disposition of any long-held capital asset by such corporation or subsidiary during the disposition period.

"(B) SPECIAL RULE FOR SECTION 1231 PROPERTY.—If the section 1231 gains of any applicable corporation or qualified subsidiary from the disposition of long-held capital assets during the disposition period exceed the section 1231 losses from such dispositions, such gains shall be taken into account under subparagraph (A)(ii) only to the extent of the lesser of the amount by which—

"(i) such gains exceed such losses, or

"(ii) the section 1231 gains for all property disposed of during the disposition period exceed the section 1231 losses for all property disposed of during such period.

"(4) DEFINITIONS.—

"(A) QUALIFIED SUBSIDIARY.—The term 'qualified subsidiary' means, with respect to any qualified acquisition of any applicable corporation, any corporation—

"(i) with respect to which such applicable corporation owned, or was treated as owning under section 318(a), immediately before the transaction date stock in such corporation which meets the requirements of section 1504(a)(2), and

"(ii) with respect to which the acquiring corporation, as a result of the qualified acquisition of such applicable corporation, made a qualified acquisition of such corporation.

"(C) LONG-HELD CAPITAL ASSET DEFINED.—The term 'long-held capital asset' means any capital asset the holding period of which at the time of disposition is 5 years or more.

"(D) SECTION 1231 GAIN AND LOSS DEFINED.—The terms 'section 1231 gain' and 'section 1231 loss' have the meanings given such terms by section 1231(a)(3).

"(c) NOTIFICATION OF BASIS ADJUSTMENT.—

"(1) IN GENERAL.—Within 60 days of the due date (determined with extensions) for filing the return of tax of any applicable corporation for the taxable year which includes the transaction date, the notifying corporation shall provide each shareholder of the applicable corporation on the transaction date with a statement including—

"(A) such shareholder's pro rata share of the aggregate basis adjustment (determined by reference to the amounts shown on the return of tax of the applicable corporation and any qualified subsidiary), and

"(B) such other information as the Secretary may prescribe.

"(2) NOTIFYING CORPORATION.—For purposes of this paragraph, the term 'notifying corporation' means—

"(A) in the case of a qualified acquisition, the acquiring corporation, and

"(B) in any other case, the liquidating corporation.

"(d) IMPOSITION OF TAX IF BASIS ADJUSTMENT TOO LARGE.—

"(1) IN GENERAL.—If, by reason of determining the aggregate basis adjustment on the basis of the tax imposed on any applicable corporation or qualified subsidiary, the amount of such adjustment would be decreased, there is hereby imposed on such applicable corporation for the taxable year including the transaction date a tax in the amount determined under paragraph (2).

"(2) AMOUNT OF TAX.—

"(A) IN GENERAL.—The amount of the tax determined under paragraph (1) shall be equal to 20 percent of the amount of the decrease determined under such paragraph.

"(B) NO CREDITS AGAINST TAX.—No credit shall be allowed under this chapter against the tax imposed by subparagraph (A).

"(3) TAX IN ADDITION TO OTHER TAXES.—Any tax imposed under paragraph (1) shall be in addition to any other tax imposed by this chapter.

"(e) DEFINITIONS RELATING TO ELIGIBLE SHAREHOLDERS.—For purposes of this section—

"(1) ELIGIBLE SHAREHOLDER.—

"(A) IN GENERAL.—The term 'eligible shareholder' means any person who holds stock of the applicable corporation on the transaction date, but only if the gain on the disposition of such stock on such date would be long-term capital gain.

"(B) PRIOR HOLDER WHERE GAIN NOT LONG-TERM CAPITAL GAIN ON TRANSACTION DATE.—If subparagraph (A) does not apply to any stock because the gain would not be long-term capital gain, the eligible shareholder shall be the person (if any)—

"(i) who disposed of such stock during the 6-month period ending on the transaction date, and

"(ii) with respect to whom gain or loss on such disposition was long-term capital gain or loss.

"(2) PRO RATA SHARE.—An eligible shareholder's pro rata share of the aggregate basis adjustment shall be the amount which bears the same ratio to such adjustment as—

"(A) the fair market value of the stock in the applicable corporation held by such shareholder as of the transaction date, bears to

"(B) the fair market value of all stock in such corporation as of such date.

"(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) SECTION 1060 TRANSACTION.—The term 'section 1060 transaction' includes any—

"(A) qualified acquisition, or

"(B) liquidation of a any corporation to which section 331 applies (determined without regard to any election under section 333).

"(2) APPLICABLE CORPORATION.—The term 'applicable corporation' means—

"(A) the target corporation in a qualified acquisition, and

"(B) the corporation being liquidated in a transaction described in paragraph (1)(B).

"(3) TRANSACTION DATE.—The term 'transaction date' means—

"(A) in the case of a qualified acquisition, the acquisition date, and

"(B) in any other case, the date on which all of the assets of the corporation (less assets retained to meet claims of shareholders or creditors) have been distributed in complete liquidation.

"(4) DISPOSITION PERIOD.—The term 'disposition period' means the 12-month period ending with the transaction date.

"(5) STOCK NOT TO INCLUDE CERTAIN PREFERRED STOCK.—The term 'stock' does not include any stock described in section 1504(a)(4).

"(6) TIME ADJUSTMENT MADE.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any increase in basis under subsection (a) shall be made as of the beginning of the transaction date.

"(B) SPECIAL RULE WHERE ELIGIBLE SHAREHOLDER DISPOSES OF STOCK BEFORE TRANSACTION DATE.—In the case of an eligible shareholder described in subsection (c)(1)(B), any increase in basis under subsection (a) shall be treated as having been made immediately before such shareholder disposed of the stock.".

(b) PENALTY FOR FAILURE TO PROVIDE STATEMENT.—Section 6678(a)(3) (relating to penalty to furnishing certain statements) is amended—

(1) by striking out "or" at the end of subparagraph (E),

(2) by inserting "or" at the end of subparagraph (F), and

(3) by inserting after subparagraph (F) the following new subparagraph:

"(G) section 1060(c) (relating to statements furnished to shareholders of certain corporations),".

(c) CONFORMING AMENDMENT.—The table of sections for part IV of subchapter O of chapter 1 is amended by striking out the item relating to section 1060 and inserting in lieu thereof the following new items:

"Sec. 1060. Increase in basis of eligible shareholder's stock to reflect corporate level tax paid in certain acquisitions and liquidations of small business corporations.
"Sec. 1061. Cross references.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to acquisitions and liquidations made after December 31, 1985.

## Subtitle B—Other Provisions Relating to Gain or Loss

### SEC. 211. NO GAIN OR LOSS RECOGNIZED ON EXCHANGE OF STOCK OF CONTROLLING CORPORATION.

Subsection (a) of section 1032 (relating to exchange of stock for property) is amended to read as follows:

"(a) NONRECOGNITION OF GAIN OR LOSS.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of—

"(1) such corporation, or

"(2) a corporation which owns, or is treated as owning under section 318(a) (without regard to paragraph (3)(C) or (4) thereof), stock representing control of the corporation described in paragraph (1).".

No gain or loss shall be recognized by an corporation with respect to any lapse or acquisition of an option to buy or sell stock (including treasury stock) of such corporation or a corporation described in paragraph (2).".

### SEC. 212. CHARACTER OF GAIN ON DISPOSITION OF CERTAIN PROPERTY BY CORPORATION DETERMINED BY REFERENCE TO SHAREHOLDERS.

(a) IN GENERAL.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

### "SEC. 1257. GAIN ON CERTAIN PROPERTY HELD BY CORPORATION DETERMINED BY REFERENCE TO SHAREHOLDER.

"(a) GENERAL RULE.—If any corporation disposes of any property to which this section applies during the applicable period, then, notwithstanding any other provision of this title, gain from such disposition shall be treated as ordinary income.

"(b) PROPERTY TO WHICH THIS SECTION APPLIES.—This section shall apply to—

"(1) CONTRIBUTIONS TO CAPITAL.—Any property transferred to a corporation by any shareholder as a contribution to capital the gain on which would, if held by such shareholder, be ordinary income.

"(2) PROPERTY MANUFACTURED, ETC., BY CORPORATION WHICH WOULD BE ORDINARY INCOME PROPERTY IN HANDS OF SUBSTANTIAL SHAREHOLDERS.—Any property—

"(A) which is manufactured, constructed, produced, purchased, or otherwise acquired by any corporation, and

"(B) the gain on which would, if held by 1 or more shareholders of such corporation holding a substantial portion of the stock of such corporation, be treated as ordinary income.

"(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) APPLICABLE PERIOD.—The term 'applicable period' means the 3-year period beginning—

"(A) in the case of property described in subsection (b)(1), the date on which such property is transferred to the corporation, and

"(B) in the case of property described in subsection (b)(2), the date on which the holding period of such corporation with respect to such property begins.

"(2) MEMBERS OF AFFILIATED GROUP.—In the case of a corporation which is a member of an affiliated group (within the meaning of section 1504(a) but without regard to section 1504(b)), all members of such group shall be treated as 1 corporation.".

(b) CONFORMING AMENDMENT.—The table of sections for part IV of subchapter V of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 1257. Gain on certain property held by corporation determined by reference to shareholder.".

### SEC. 213. AMENDMENTS TO SECTION 1248.

(a) SPECIAL RULE FOR QUALIFIED STOCK ACQUISITION.—Section 1248(c) (relating to determination of earnings and profits) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULE FOR QUALIFIED STOCK ACQUISITIONS.—For purposes of determining the earnings and profits of any foreign corporation for purposes of this section, in the case of a qualified stock acquisition (within the meaning of section 364(b)) of such foreign corporation which an acquiring corporation elects to treat as a cost basis acquisition under section 365(b), the deemed sale and purchase under section 361(b) shall be treated as having occurred immediately before the acquisition of stock.".

(b) TREATMENT OF CORPORATIONS 70 PERCENT OF THE ASSETS OF WHICH WOULD BE ORDINARY INCOME PROPERTY IN HANDS OF SHAREHOLDER.—Section 1248 is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) SPECIAL RULE WHERE 70 PERCENT OF ASSETS OF FOREIGN CORPORATION WOULD BE ORDINARY INCOME PROPERTY IN HANDS OF SHAREHOLDER.—

"(1) IN GENERAL.—If—

"(A) subsection (a) would (but for this subsection) apply to any sale or exchange of stock of any foreign corporation by a United States person, and

"(B) more than 70 percent of the assets of such corporation are assets to which section 1257 applies,

then subsection (a) shall not apply and any gain on the sale or exchange of such stock by such United States person shall be treated as ordinary income.

"(2) ASSETS HELD 3 OR MORE YEARS NOT TAKEN INTO ACCOUNT.—For purposes of paragraph (1), there shall not be taken into account any asset to which section 1257 applies if the holding period of such asset in the hands of the foreign corporation at the time of disposition of the stock is 3 or more years.".

**SEC. 214. MODIFICATIONS RELATING TO SUBCHAPTER S.**

(a) IN GENERAL.—Section 1367 (relating to adjustments to basis of stock of shareholders, etc.) is amended by adding at the end thereof the following new subsection:

"(c) SPECIAL RULES FOR GAIN ON DISPOSITION BY S CORPORATION (OTHER THAN CERTAIN SMALL CORPORATIONS) OF ASSETS FORMERLY HELD BY C CORPORATIONS.—

"(1) NO INCREASE IN BASIS FOR CERTAIN GAIN.—Except as provided in this subsection, in any case to which this subsection applies, no increase shall be made in the basis of any shareholder's stock in an S corporation with respect to the applicable percentage of—

"(A) 50 percent of the gain other than long-term capital gain, and

"(B) 80 percent of the long-term capital gain,

recognized by the S corporation on the disposition of any of its assets during the 5-year period beginning with the transfer date.

"(2) APPLICATION OF SUBSECTION.—This subsection applies to any case in which—

"(A) a C corporation elects under section 1362(a) to be an S corporation, or

"(B) an S corporation makes a qualified asset acquisition (within the meaning of section 364(c)) of a C corporation which is a carryover basis acquisition.

"(3) Applicable Percentage.—

"(A) In general.—The term 'applicable percentage' means 10 percent for each $100,000 by which the value of the stock in the C corporation immediately before the transfer date exceeds $1,000,000. The applicable percentage shall not exceed 100 percent.

"(B) Certain transactions disregarded.—The Secretary may by regulation provide that any disposition of stock or asset or other transaction be disregarded if the principal purpose of such transaction is to decrease the applicable percentage under subparagraph (A).

"(4) Subsection not to apply to certain gains.—This subsection shall not apply to—

"(A) Assets held 5 or more years.—Gain on the disposition of any property—

"(i) which is—

"(I) a capital asset, or

"(II) property the gain or loss of which is section 1231 gain or loss (within the meaning of section 1231(a)(3)), and "(ii) with respect to which the holding period in the hands of the S corporation at the time of disposition is 5 or more years.

"(B) S CORPORATION DATE GAIN.—Gain on any asset which the S corporation establishes is allocable to periods which the asset was held by the S corporation and the election under section 1362 was in effect.

"(C) BUILT-IN GAIN.—Gain on the disposition of any asset to the extent, when added to gain on any prior disposition to which the subsection applied, exceeds the built-in gain immediately before the transfer date.

"(5) APPLICATION WITH SECTION 1374.—

"(A) IN GENERAL.—Any gain to which paragraph (1) applies shall not be taken into account for purposes of section 1374.

"(B) S CORPORATION MAY ELECT APPLICATION OF THIS SUBSECTION.—If, but for this subparagraph, paragraph (1) does not apply to any portion of any gain, the S corporation may elect to have paragraph (1) apply to such portion.

"(6) BUILT-IN GAIN.—For purposes of this subsection, the term 'built-in gain' means the excess of—

"(A) the fair market value of the assets of the C corporation immediately before the transfer date, over

"(B) the aggregate adjusted basis of such assets immediately before the transfer date.

"(7) TRANSFER DATE.—For purposes of this subsection, the term 'transfer date' means—

"(A) in any case described in paragraph (3)(A)(i), the date on which the election takes effect, and

"(B) in any case described in paragraph (3)(A)(ii), the acquisition date.".

(b) MODIFICATION OF ACCUMULATED ADJUSTMENTS ACCOUNTS.—

(1) IN GENERAL.—Section 1368(e)(1) (relating to accumulated adjustments accounts) is amended by adding at the end thereof the following new subparagraph:

"(C) SPECIAL RULE WHERE BASIS OF STOCK NOT INCREASED UNDER SECTION 1367.—In any case to which section 1367(c) applies, the accumulated adjustments account shall, on the date which is 5 years after the transfer date (within the meaning of section 1367(c)(7)), be increased by the amount of gain which was not taken into account in increasing basis by reason of section 1367(c).".

(2) CONFORMING AMENDMENT.—Subparagraph (A) of section 1368(e)(1) is amended by striking out "subparagraph (B)" and inserting in lieu thereof "subparagraph (B) or (C)".

### SEC. 215. EFFECTIVE DATES.

(a) IN GENERAL.—Except as provided in this section, the amendments made by this subtitle shall apply to dispositions made after December 31, 1985, in taxable years ending after such date.

(b) SECTION 214.—The amendments made by section 214 shall apply to—

(1) elections under section 1362 of the Internal Revenue Code of 1954 made after December 31, 1985, and

(2) acquisitions made after December 31, 1985.

## TITLE III—LIMITATIONS ON TAX CARRYOVERS

### SEC. 301. SHORT TITLE.

This title may be cited as the "Tax Carryover Limitation Act of 1985".

### SEC. 302. LIMITATIONS ON TAX CARRYOVERS.

(a) IN GENERAL.—Part V of subchapter C of chapter 1 (relating to special limitations on carryovers) is amended by striking out section 382 and inserting in lieu thereof the following new sections:

### "SEC. 382. LIMITATION ON NET OPERATING LOSS CARRYOVERS AND CERTAIN BUILT-IN LOSSES FOLLOWING CHANGE IN CONTROL.

"(a) GENERAL RULE.—In the case of any ownership change (within the meaning of section 382A(a)) of any old loss corporation, the amount of the taxable income of the new loss corporation for any post-change year which may be offset by 1 or more pre-change losses shall not exceed the section 382 limitation for such year.

"(b) SECTION 382 LIMITATION.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to the sum of—

"(A) the product of—

"(i) the value of the old loss corporation immediately before the change, multiplied by

"(ii) the Federal long-term rate in effect under section 1274(d) on the date of the change,

"(B) the recognized built-in gain amount for such post-change year, and

"(C) the amount of any carryover of any unused section 382 limitation to such post-change year under paragraph (2).

"(2) CARRYOVER OF UNUSED LIMITATION.—

"(A) IN GENERAL.—If the section 382 limitation for any post-change year exceeds the taxable income of the new loss corporation which was offset by pre-change losses, the section 382 limitation for the succeeding post-change year shall be increased by the amount of such excess.

"(B) ORDERING RULE FOR LOSSES CARRIED FROM SAME TAXABLE YEAR.—In any case in which—

"(i) a pre-change loss of a loss corporation for any taxable year is subject to the section 382 limitation, and

"(ii) a net operating loss of such corporation from such taxable year is not subject to such limitation,

taxable income shall, for purposes of subparagraph (A), be treated as having been offset first by the loss subject to such limitation.

"(3) SPECIAL RULE FOR POST-CHANGE YEAR WHICH INCLUDES DATE OF CHANGE.—In the case of any post-change year which includes the date of the change, the section 382 limitation shall be equal to the sum of--

"(A) the amount which bears the same ratio to such limitation (determined without regard to this paragraph) as—

"(i) the number of days in such year following the change, bears to

"(ii) the total number of days in such year, and

"(B) the taxable income for such year which is allocable (determined on a pro rata basis) to the period in such year up to and including the date of the change.

"(c) DEFINITION OF PRE-CHANGE LOSS AND POST-CHANGE YEAR.—For purposes of this part—

"(1) PRE-CHANGE LOSS.—The term 'pre-change loss' means—

"(A) the net operating loss of the old loss corporation for the taxable year in which the change occurs which is allocable (determined on a pro rata basis) to the period in such year up to the date of the change,

"(B) any such net operating loss for any taxable year preceding the taxable year in which the change occurs, and

"(C) any recognized built-in loss.

"(2) POST-CHANGE YEAR.—The term 'post-change year' means any taxable year ending after the date of the change.

"(d) VALUE OF OLD LOSS CORPORATION.—For purposes of this section, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the change.

"(e) SPECIAL RULES FOR BUILT-IN GAINS AND LOSSES.—For purposes of this section—

"(1) RECOGNIZED BUILT-IN GAIN.—The term 'recognized built-in gain' means the amount of gain recognized during any taxable year within the recognition period on the disposition of any asset to the extent such gain, when added to the recognized built-in gain for any preceding taxable year within such period, does not exceed the built-in gain of the old loss corporation.

"(2) RECOGNIZED BUILT-IN LOSS.—The term 'recognized built-in loss' means the amount of any loss recognized during any taxable year within the recognition period on the disposition of any asset to the extent such loss, when added to any recognized built-in loss for any preceding taxable year within such period, does not exceed the built-in loss of the old loss corporation.

"(3) GAIN OR LOSS ALLOCABLE TO POST-CHANGE YEARS NOT TAKEN INTO ACCOUNT.—For purposes of this subsection—

"(A) gain on any disposition shall be treated as recognized built-in gain only to the extent the taxpayer establishes that such gain is allocable to any period before the change, and

"(B) loss on any disposition shall be treated as recognized built-in loss except to the extent the taxpayer establishes that such loss is allocable to any period after the change.

"(4) BUILT-IN GAIN AND LOSS DEFINED.—

"(A) BUILT-IN GAIN AND LOSS.—

"(i) IN GENERAL.—The terms 'built-in gain' and 'built-in loss' mean, with respect to any old loss corporation, the amount by which—

"(I) the fair market value of the assets of such corporation immediately before the change, is more or less, respectively, than,

"(II) the aggregate adjusted basis of such assets as of such time.

"(ii) CASH AND CASH ITEMS NOT TAKEN INTO ACCOUNT.—In computing any built-in gain or loss under clause (i), there shall not be taken into account—

"(I) any cash or cash item, or

"(II) any Government security with a maturity (at issue) of less than 3 years.

"(B) THRESHOLD REQUIREMENT.—If the amount of the built-in gain or built-in loss of any old loss corporation (determined without regard to this subparagraph) is not greater than 25 percent of the amount determined under subclause (I) of subparagraph (A)(i), the built-in gain or loss shall be treated as zero.

"(C) SECRETARY MAY TREAT CERTAIN DEDUCTIONS AS BUILT-IN LOSSES.—The Secretary may by regulation treat amounts which accrue before the date of the change but which are allowable as a deduction on or after such date as built-in losses.

"(5) RECOGNITION PERIOD.—The term 'recognition period' means the first post-change year and the 4 succeeding post-change years, except that if such first year includes the date of the change, only such date and days following such date shall be taken into account.

"(f) OTHER SPECIAL RULES.—

"(1) SPECIAL RULES FOR SUCCESSIVE CHANGES.—In any case in which a change of an old loss corporation is followed by a change of the new loss corporation—

"(A) PRE-CHANGE LOSSES.—If the section 382 limitation for the second change is—

"(i) less than or equal to the section 382 limitation for the first change, the section 382 limitation for the second change shall apply to all pre-change losses (and the section 382 limitation for the first change shall not apply), or

"(ii) greater than the section 382 limitation for the first change—

"(I) except as provided in subparagraph (B), the pre-change loss for the second change shall not include any pre-change loss which is subject to limitation under subsection (a) by reason of the first change, and

"(II) the section 382 limitation for any post-change year with respect to the second change shall be reduced (but not below zero) by the amount of taxable income which is offset by pre-change losses subject to the section 382 limitation with respect to the first change.

"(B) RECOGNIZED BUILT-IN GAINS AND LOSSES.—In any case to which subparagraph (A)(ii) applies—

"(i) CERTAIN RECOGNIZED BUILT-IN LOSSES.—The pre-change loss for the second change shall include (and the pre-change loss for the first change shall not include) any recognized built-in loss recognized on or after the second change.

"(ii) RECOGNIZED BUILT-IN GAIN.—Recognized built-in gain recognized on or after the second change shall be taken into account in applying this section to the second change (and not the first change).

"(2) CERTAIN CAPITAL CONTRIBUTIONS NOT TAKEN INTO ACCOUNT.—

"(A) IN GENERAL.—Any capital contributions received by any old loss corporation as part of a plan the principal purpose of which is to avoid any limitation under this section shall not be taken into account for purposes of this section.

"(B) CERTAIN CONTRIBUTIONS PRESUMED TO BE PART OF PLAN.—For purposes of subparagraph (A), any capital contribution made within 2 years of the date of the change shall, except as provided in regulations, be treated as part of a plan described in subparagraph (A).

"(3) NO carryover ALLOWED IN THE CASE OF AN INVESTMENT COMPANY.—

"(A) IN GENERAL.—If, immediately before the change, the old loss corporation is an investment company, the section 382 limitation shall be zero.

"(B) INVESTMENT COMPANY.—For purposes of subparagraph (A), the term 'investment company' means any corporation if at least 2/3 of the value of the total assets of such corporation consists of assets held for investment, but such term shall not include a regulated investment company to which part I of subchapter M applies or a real estate investment trust to which part II of subchapter M applies.

"(C) TREATMENT OF SUBSIDIARIES.—For purposes of subparagraph (B), stock and securities held by any parent corporation in any subsidiary corporation shall be disregarded and such parent corporation shall be deemed to own its ratable share of the subsidiary's assets. For purposes of the preceding sentence, a corporation shall be treated as a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of shares of all classes of stock outstanding.

"(4) TITLE 11 OR SIMILAR CASE.—

"(A) IN GENERAL.—In any case in which the old loss corporation—

"(i) is under the jurisdiction of the court in a title 11 or similar case (within the meaning of section 366(h)) immediately before the change, and

"(ii) the shareholders and creditors of such corporation (immediately before the change) own (immediately after the change) stock of the new loss corporation which meets the requirements of section 1504(a)(2) (determined by substituting '50 percent' for '80 percent' each place it appears),

then subsection (a) shall not apply to the pre-change loss of such corporation.

"(B) REDUCTION FOR INTEREST PAYMENTS TO CREDITORS BECOMING SHAREHOLDERS.—In any case to which subparagraph (A) applies, the net operating loss deduction under section 172(a) for any post-change year shall be determined as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation during the 3 taxable years preceding the taxable year in which the change occurs on indebtedness which was converted into stock pursuant to the title 11 or similar case.

"(C) SECTION 382 LIMITATION ZERO IF ANOTHER CHANGE WITHIN 2 YEARS.—If, within 2 years of the change to which this paragraph applies, another change occurs, this paragraph and paragraph (1) shall not apply and the section 382 limitation with respect to such second change shall be zero.

"(g) DEFINITIONS.—For purposes of this part—

"(1) LOSS CORPORATION.—The term 'loss corporation' means a corporation entitled to use a net operating loss carryover, excess credit carryover, or capital loss carryover.

"(2) OLD LOSS CORPORATION.—The term 'old loss corporation' means the corporation which (before the change) was a loss corporation.

"(3) NEW LOSS CORPORATION.—The term 'new loss corporation' means a corporation which (after the change) is a loss corporation. The old loss corporation and the new loss corporation may be the same corporation.

"(4) TAXABLE INCOME.—Taxable income shall be computed with the modifications set forth in section 172(d).

"(5) VALUE.—The term 'value' means fair market value.

### "SEC. 382A. DEFINITIONS AND RULES RELATING TO CHANGES OF CONTROL TO WHICH SECTION 382 LOSS LIMITATIONS APPLY.

"(a) OWNERSHIP CHANGE; CHANGE.—For purposes of this part, the terms 'ownership change' and 'change' mean—

"(1) a more than 50-percent owner shift, or

"(2) a more than 50-percent equity structure change in a qualified asset acquisition.

"(b) MORE THAN 50-PERCENT OWNER SHIFT.—For purposes of this section—

"(1) IN GENERAL.—There is a more than 50-percent owner shift if, immediately after any owner shift, the aggregate total value of the stock of the old loss corporation held (or treated as held under subsection (d)) by all 5-percent shareholders has increased or decreased by more than 50 percentage points over such holdings by such shareholders at any time during the testing period.

"(2) EXCLUSION OF EQUITY STRUCTURE CHANGE.—The term 'more than 50-percent owner shift' does not include any more than 50-percent equity structure change.

"(3) OWNER SHIFT DEFINED.—The term 'owner shift' means any change in the respective holdings in the stock of a corporation.

"(c) MORE THAN 50-PERCENT EQUITY STRUCTURE CHANGE.—For purposes of this section—

"(1) IN GENERAL.—There is a more than 50-percent equity structure change if, immediately after a qualified asset acquisition—

"(A) the total value of the stock of the new loss corporation held (or treated as held under subsection (d)) by shareholders of the old loss corporation is more than 50 percentage points less than,

"(B) the total value of the stock of the old loss corporation held (or so treated as held) by such shareholders at any time during the testing period.

"(2) TREATMENT OF REVERSE MERGERS.—The Secretary shall prescribe regulations to provide for the application of this part in cases where the shareholders of the old loss corporation own stock of the new loss corporation meeting the requirements of section 1504(a)(2) (determined by substituting '50 percent' for '80 percent' each place it appears) immediately after a qualified asset acquisition.

"(3) QUALIFIED ASSET ACQUISITION.—The term 'qualified asset acquisition' has the meaning given such term by section 364(c).

"(d) OPERATING RULES RELATING TO OWNERSHIP OF STOCK.—For purposes of this section—

"(1) CONSTRUCTIVE OWNERSHIP.—Section 318 (relating to constructive ownership of stock) shall apply in determining ownership of stock, except that—

"(A) paragraph (2)(C) of section 318(a) shall be applied without the 50-percent limitation contained therein,

"(B) paragraph (3)(C) of section 318(a) shall be applied—

"(i) without the 50-percent limitation contained therein, and "(ii) by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such sharholder owns in such corporation bear to the value of all stock in such corporation, and

"(C) paragraph (4) of section 318(a) shall not apply.

"(2) STOCK ACQUIRED BY REASON OF DEATH, GIFT, DIVORCE, OR SEPARATION.—If—

"(A) the basis of any stock in the hands of any person is determined under section 1014 (relating to property acquired from a decedent) or section 1015 (relating to property acquired by gift or transfers in trust),

"(B) stock is received by any person in satisfaction of a right to receive a pecuniary bequest, or

"(C) stock is acquired pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)),

the receipt or acquisition of such stock shall not be taken into account in determining whether an ownership change has occurred.

"(3) SPECIAL RULE FOR EMPLOYEE STOCK OWNERSHIP PLANS.—The acquisition of employer securities (within the meaning of section 409(l)) by—

"(A) a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7), or

"(B) by a participant of any such plan pursuant to the requirements of section 409(h),

shall not be taken into account in determining whether an ownership change has occurred.

"(4) CERTAIN CHANGES IN PERCENTAGE OWNERSHIP WHICH ARE ATTRIBUTABLE TO FLUCTUATIONS IN VALUE NOT TAKEN INTO ACCOUNT.—Under regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.

"(e) TESTING PERIOD.—For purposes of this section—

"(1) 3-YEAR PERIOD.—Except as otherwise provided in this section, the testing period is the 3-year period ending on the day before the owner shift or qualified asset acquisition with respect to which a determination is being made under this section.

"(2) SHORTER PERIOD WHERE THERE HAS BEEN RECENT CHANGE.—The testing period for determining whether any change has occurred shall not begin before the 1st day following the testing period for any earlier change.

"(3) SHORTER PERIOD WHERE ALL LOSSES ARISE AFTER 3-YEAR PERIOD BEGINS.—The testing period shall not begin before the 1st day of the 1st taxable year from which there is a carryover (whether of a net operating loss, a capital loss, or an excess credit) to the 1st post-change year.

"(f) TIME WHEN CHANGE OCCURS.—For purposes of this part, a change shall be treated as having occurred on—

"(1) in the case of a more than 50-percent owner shift, the date on which such shift occurs, and

"(2) in the case of a more than 50-percent equity structure change, the acquisition date (within the meaning of section 366(a)(2)(B)).

"(g) RULES RELATING TO STOCK.—For purposes of this part—

"(1) STOCK DEFINED.—The term 'stock' shall not include any preferred stock described in section 1504(a)(4).

"(2) TREATMENT OF CERTAIN RIGHTS, ETC.—The Secretary shall prescribe such regulations as may be necessary—

"(A) to treat warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock, and

"(B) to treat options to acquire or sell stock as having been exercised.

"(3) DETERMINATIONS ON BASIS OF VALUE.—Determinations of the percentage of stock of any corporation held by any person shall be made on the basis of value.

"(4) 5-PERCENT SHAREHOLDER.—The term '5-percent shareholder' means any person holding (or treated as holding under subsection (d)) at any time during the testing period 5 percent or more of the value of the stock of any corporation.".

(b) AMENDMENT OF SECTION 383.—Section 383 (relating to special limitations on unused investment credits, etc.) is amended to read as follows:

**"SEC. 383. SPECIAL LIMITATIONS ON CERTAIN EXCESS CREDITS, ETC.**

"(a) EXCESS CREDITS.—

"(1) IN GENERAL.—In any case to which section 382(a) applies, under regulations, the amount of the tax liability of the new loss corporation for any post-change year which may be offset by one or more pre-change excess credits shall not exceed the amount of the tax liability for such post-change year which is attributable to that portion of the taxable income for such post-change year as is equal to the excess (if any) of—

"(A) the section 382 limitation for such post-change year, over

"(B) the amount of the pre-change loss taken into account (after the application of section 382) in determining the amount of the taxable income for such post-change year.

"(2) EXCESS CREDIT.—For purposes of paragraph (1), the term 'excess credit' means—

"(A) any unused general business credit of the corporation under section 39, and

"(B) any unused credit of the corporation under section 30(g)(2) (relating to credit for increasing research activities).

"(b) LIMITATION ON NET CAPITAL LOSS.—In any case to which section 382(a) applies, the amount of the taxable income of the new loss corporation for any post-change year which may be offset by one or more pre-change capital losses (including capital losses recognized on or after the change but which are allocable to periods before the change) shall be limited under regulations which shall be based on the principles applicable under sections 382 and 382A. Such regulations shall provide that any pre-change capital loss used in a post-change year shall reduce the amount of any pre-change loss which may be used in a post-change year under section 382(a).

"(c) FOREIGN TAX CREDITS.—In any case to which section 382(a) applies, the amount of any excess foreign taxes under section 904(c) for any period before the ownership change shall be limited under regulations.

"(d) PRE-CHANGE CREDITS AND CAPITAL LOSSES.—For purposes of this section, the terms 'pre-change excess credit' and 'pre-change capital loss' means—

"(1) any excess credit or capital loss of the old loss corporation for the taxable year in which the change occurs which is allocable (determined on a pro rata basis) to the period in such year up to the date of the change, and

"(2) any such excess credit or capital loss for any taxable year preceding the taxable year in which the change occurs.".

(c) APPLICATION WITH SECTION 269.—Section 269 (relating to acquisitions made to evade or avoid income tax) is amended by adding at the end thereof the following new subsection:

"(d) APPLICATION WITH SECTIONS 382 AND 383.—This section shall not apply to disallow the deduction for any loss or any credit to which section 382 or 383 applies.".

(d) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 172(b) (relating to amount of carrybacks and carryovers) is amended by striking out "and" at the end of subparagraph (A), by inserting "and" at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph:

"(C) by reducing such taxable income by the amount of such income which may not be offset by such loss by reason of section 382(a),".

(2) Paragraph (5) of section 318(b) is amended by striking out "section 382(a)(3)" and inserting in lieu thereof "section 382A(d)".

(3) The table of sections for part V of subchapter C of chapter 1 is amended by striking out the item relating to section 382 and inserting in lieu thereof the following new items:

"Sec. 382. Limitation on net operating loss carryovers and certain built-in losses following change in control.
"Sec. 382A. Definitions and rules relating to changes of control to which section 382 loss limitations apply.".

(e) REPEAL OF CHANGES MADE BY TAX REFORM ACT OF 1976.—

(1) Subsections (e) and (f) of section 806 of the Tax Reform Act of 1976 are hereby repealed.

(2) Subsection (g) of such section 806 is amended by striking out paragraphs (2) and (3).

(3) The repeals made by paragraph (1) and the amendment made by paragraph (2) shall not affect the amendment to section 383 of the Internal Revenue Code of 1954 made by subsection (f) of such section 806.

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—

(A) The amendments made by subsections (a), (b), (c), and (d) shall apply to any change (as defined in section 382A, as added by this section) occurring after December 31, 1985.

(B) For purposes of determining whether there is such a change after December 31, 1985, the testing period shall not begin before January 1, 1986.

(2) FOR AMENDMENTS TO TAX REFORM ACT OF 1976.—The repeals made by subsection (e)(1) and the amendment made by subsection (e)(2) shall take effect on January 1, 1986.

# PART THREE: TECHNICAL EXPLANATION OF SUBCHAPTER C REVISION ACT OF 1985

# TECHNICAL EXPLANATION OF SUBCHAPTER C REVISION ACT OF 1985

The bill is organized as follows:

## Title I. General Revision of Subchapter C

### SUBTITLE A—CORPORATE ORGANIZATIONS AND ACQUISITIONS

Section 101—Corporate Organizations and Acquisitions. This section amends Part III of Subchapter C, sections 351 through 368.

### SUBTITLE B—CORPORATE DISTRIBUTIONS

Section 111—Corporate Recognition of Gain or Loss on Distributions of Property by Corporations. This section amends section 311.

### SUBTITLE C—CORPORATE LIQUIDATIONS

Section 121—Repeal of Sections 336, 337, 338, and 341.
Section 122—Modification of Section 333 Election.
Section 123—Effective Dates.

### SUBTITLE D—TECHNICAL AND CONFORMING CHANGES

Section 131—Technical and Conforming Changes.

## Title II. Provisions Relating to Gain and Loss of Shareholders of Corporations

### SUBTITLE A—BASIS ADJUSTMENTS

Section 201—Basis of Controlling Corporate Shareholder in Subsidiary. This section adds new section 1020.
Section 202—Basis Adjustments to Reflect Corporate Level Tax Paid in Certain Corporate Acquisitions and Liquidations. This section adds new section 1060.

### SUBTITLE B—OTHER PROVISIONS RELATING TO GAIN OR LOSS

Section 211—No Gain or Loss Recognized on Exchange of Stock of Controlling Corporation. This section amends section 1032.
Section 212—Character of Gain on Disposition of Certain Property by Corporation Determined by Reference to Shareholders. This section adds new section 1257.
Section 213—Amendment to Section 1248.
Section 214—Modifications Relating to Subchapter S. This section amends sections 1367 and 1368.
Section 215—Effective Dates.

## Title III. Limitations on Tax Carryovers

Section 301—Short Title.
Section 302—Limitations on Tax Carryovers. This section adds new sections 382, 382A, and 383.

## Section 101—Corporate Organizations and Acquisitions

1. *Section 351*— Section 351 has been amended in the following respects:

a. Treatment of securities—Under current law, securities as well as stock of the transferee may be received in a section 351 transaction without the recognition of gain or loss. Under the bill, the general nonrecognition rule does not apply to the extent the issue price of any securities of the transferee received exceeds the adjusted basis of any securities of the transferee surrendered in the exchange. Any excess is treated as boot received by the transferor in the exchange. The term "issue price" has the same meaning as under current law sections 1273(b) and 1274(a).

If a security or other debt instrument constitutes boot to the transferor, the installment method may be available to defer the reporting of gain. For the determination of the transferee's basis in property transferred to a section 351 transaction where all or a portion of the transferor's gain is deferred under section 453, see section 362.

b. Definition of "control"—Under current law, the term "control" for purposes of section 351 means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Under the bill, the definition of "control" for purposes of section 351 is conformed to the meaning contained in section 1504(a)(2), taking into account sections 1504(a) (4) and (5). Thus, the term "control" means generally the ownership of stock possessing at least 80 percent of the total voting power of the stock of such corporation, and having a value equal to at least 80 percent of the total value of the stock of such corporation.

c. Installment sales between shareholders and controlled corporations—Under current law, an installment sale of property between a corporation and its controlling shareholder may not be subject to section 351. *See Warren H. Brown* v. *Commissioner,* 27 T.C. 27 (1956). Under the bill, in the case of an installment sale of property to a corporation by any 20 percent shareholder of such corporation, both the property transferred for the note and the installment note received shall be treated as part of a section 351 exchange. For this purpose, a "20 percent shareholder" is any shareholder owning stock described in section 1504(a)(2), except that "20 percent" is substituted for "80 percent" in applying that provision.

Thus, for example, assume that A owns 50 percent of corporation X, and A sells property to X on the installment method in exchange for an installment note plus additional stock of X. After the sale, A owns 60 percent of X. In this transaction, the portion of the property transferred in exchange for the note will be treated under the bill as having been transferred in a section 351 exchange. As under current law, the portion of the property transferred in exchange for the additional X stock will be treated as transferred in a taxable exchange.

d. Control immediately after the exchange—Under current law, it is unclear whether a section 351 transaction followed immediately (as part of an overall plan) by the transfer of the stock or assets of the controlled corporation satisfies the requirement under section 351 that the transferor must have control of the transferee immediately after the exchange.

Under the bill, it is clarified that in the case of a section 351 transaction or a contribution to capital followed immediately (as part of an overall plan) by a qualified acquisition of the controlled corporation by another corporation, the requirement that the transferor must have control of the transferee immediately after the exchange shall be considered satisfied, and the step transaction doctrine shall not operate to defeat the form of the transaction, where (i) the transferor is a corporation, and (ii) the assets transferred constitute such assets as are sufficient for the "active conduct of a trade or business" (within the meaning of current law section 355(b)(2), but disregarding the five-year requirement) by the transferee. Thus, the provision will apply if the assets transferred, by themselves, are sufficient for the transferee to conduct actively a trade or business. No inference is intended in cases where the above requirements are not satisfied.

In addition, under current law, a transfer by one corporation of part of its assets to a controlled corporation followed by a distribution of the controlled corporation's stock in a transaction qualifying under section 355, constitutes a divisive "D" reorganization under section 368(a)(1)(D). Under the bill, section 368 (including section 368(a)(1)(D)) is repealed. It is intended, however, that a transaction qualifying under current law as a divisive "D" reorganization will be treated as a section 351 transaction followed by a distribution under section 355.

e. Overlap—Under current law, the proper tax treatment of a transaction which qualifies as both a section 351 exchange and as a reorganization is unclear. *See* Rev. Rul. 80-284, 1980-2 C.B. 117, and Rev. Rul. 80-285, 1980-2 C.B. 119, both revoked by Rev. Rul. 84-71, 1984-19 I.R.B. 6. Under the bill, except as otherwise provided in regulations, a transaction which qualifies as both an exchange under section 351 and as a qualified acquisition shall be treated as a qualified acquisition.

2. *Section 354*—Section 354 has been significantly modified to conform to the new rules relating to qualified acquisitions. As under current law, section 354 under the bill generally provides the tax treatment to shareholders and security holders of the target corporation in a qualified stock or asset acquisition of the target where stock or securities of the target corporation is exchanged for stock or securities of a "party to the acquisition."

a. General nonrecognition rule—As under present law, the bill provides that in the case of a qualified acquisition of the target corporation, a shareholder or security holder of the target shall receive, in exchange for his target stock or securities, stock or securities of a corporation which is a "party to the acquisition" without the recognition of gain or loss. This rule applies both where the target shareholder or security holder receives the qualifying consideration directly from the acquiring entity or entities, and where the qualifying consideration is distributed to the shareholder or security holder by the target corporation. "Party to the acquisition" refers to the acquiring corporation and, where the acquiring corporation is a member of an affiliated group, the common parent of such group and any other member identified in regulations. For purposes of this section, "qualifying consideration" refers to the stock or securities which may be received under section 354 without the recognition of gain or loss.

b. Treatment of securities—Under present law, the general nonrecognition rule does not apply to the extent the principal amount of any securities received exceeds the principal amount of any securities surrendered, or to the extent securities are received and no securities are surrendered. In addition, under present law, neither the general nonrecognition rule of section 354 nor section 356 applies to the extent any consideration received is attributable to accrued interest.

Under the bill, as under section 351 as revised by the bill, the general nonrecognition rule does not apply to the extent the issue price of any securities received exceeds the adjusted basis of any securities surrendered. (If no securities are surrendered, therefore, the general nonrecognition rule does not apply to any securities received.) Any excess is treated as boot received by the target shareholder or security holder in the exchange. Where the security or other debt instrument results in boot and is issued by a party to the acquisition, the target shareholder or security holder may be entitled to installment sale treatment. See section 453(f)(6). The bill retains the current law rule for accrued interest, and the term "issue price" has the same meaning as under current law section 1273(b) and 1274(a).

c. Acquisitions after control already present—The bill clarifies that in a stock-for-stock transaction, the general nonrecognition rule applies to the receipt of qualifying consideration if, immediately after the acquisition, the acquiring corporation has control of the target corporation (whether or not such control was held prior to the acquisition). In determining whether an acquiring corporation has control of the target corporation, and whether such control existed prior to the acquisition, the acquiring corporation shall be treated as holding any stock of the target held by members of the acquiring corporation's affiliated group.

Thus, assume P and S (P's wholly-owned subsidiary) have each owned 45 percent of T for several years. S issues stock to the minority T shareholders in exchange for the remaining 10 percent interest in T. Under the bill, the minority T shareholders would receive the S stock without recognition of gain or loss, even though at the corporate level, the acquisition of the 10 percent interest of T would not constitute a qualified stock acquisition, and therefore would not entitle S to make a cost basis election with respect to the T assets.

d. Overlap—Under current law, a transaction qualifying as both a "B" reorganization and a "C" reorganization may be treated as a "C" reorganization. For example, assume T's sole asset is all of the stock of S. An acquisition by P of the S stock solely for P voting stock would qualify as both a stock-for-stock "B" reorganization and a stock-for-asset (*i.e.,* all of T's assets) "C" reorganization. Treatment of the transaction as a "C" reorganization under current law permits the T shareholders to receive the P stock without recognition of gain or loss. Treatment of the transaction as a "B" reorganization, on the other hand, would not permit the T shareholders to receive the P stock without recognition of gain or loss.

Under the bill, this flexibility is retained. Thus, solely for purposes of the general nonrecognition rule of section 354, if stock is acquired in a qualified asset acquisition and is also acquired as part of a qualified stock acquisition, such stock shall be treated as acquired in the asset acquisition and not as part of the qualified stock acquisition.

e. Investment company limitation—Under present law, a transaction involving two or more investment companies must satisfy certain requirements to qualify for reorganization treatment. Failure to satisfy the requirements may result in a taxable transaction at both the corporate and shareholder levels.

Under the bill, an investment company limitation is imposed solely at the shareholder level, and does not affect the tax consequences of the transaction at the corporate level. (But see special rule in new section 365 where the acquiring corporation is a regulated investment company, as defined in section 851(a).) As a general rule, stock or securities of an investment company do not qualify for nonrecognition treatment to target shareholders or security holders. An exception applies, and nonrecognition treatment is permitted, where the target corporation was a diversified investment company on the last day of 12 of the last 16 calendar quarters ending prior to the acquisition or, for target corporations that have not been in existence for 16 calendar quarters, such period as prescribed in regulations. In general, the terms "investment company" and "diversified investment company" have the same meaning as under current law.

This provision may be illustrated by the following example. Assume that CP owns all of the stock of P, CP is an investment company, and P is not an investment company. Assume that P makes a qualified stock acquisition of T in exchange for stock of both P and CP. If T were not a diversified investment company on the last day of 12 of the last 16 calendar quarters ending prior to the acquisition, then the P stock, but not the CP stock, received by the T shareholders in the qualified acquisition would qualify for nonrecognition treatment. If T were a diversified investment company at such times, both the CP and P stock would qualify for nonrecognition treatment. In either event, availability of carryover or cost basis treatment with respect to the T assets would be unaffected. (But see special rule where the acquiring corporation is a regulated investment company, as defined in section 851(a).)

Under current law, in calculating the total assets of a corporation for purposes of determining whether the corporation constitutes an investment company and is diversified, Government securities are excluded. Under the bill, Government securities are excluded in the same computation for the same purposes, but only if they have a maturity (at issue) of 3 years or less.

For purposes of the diversification test and the definition of "investment company," the bill extends the current law meaning of "securities" to include interests described in section 1246(b)(2)(A), (B), or (C).

f. Repeals—The bill repeals current law section 354(b), (c), and (d).

3. *Section 355*—The bill makes the following change to section 355:

a. Treatment of securities—Under current law, the general nonrecognition rule of section 355 does not apply if the principal amount of securities in the controlled corporation which are received exceeds the principal amount of securities in the distributing corporation surrendered, or if securities in the controlled corporation are received and no securities are surrendered. Under the bill, in conformity with changes made to sections 351 and 354, the general nonrecognition rule does not apply to the extent the issue price of securities in the controlled corporation which are received exceeds the adjusted basis of securities in the distributing corporation surrendered. Any excess is treated as boot received in the transaction. The term "issue price" has the same meaning as under current law section 1273(b) and 1274(a).

4. *Section 356*—Along with section 354, section 356 has been significantly modified by the bill. As under current law, section 356 under the bill generally provides the tax treatment to shareholders and security holders who receive consideration other than qualifying consideration in an exchange described in section 354, or in a transaction described in section 355.

a. General gain recognition rule—As under present law, the bill provides a general gain recognition rule in the case of shareholders or security holders who receive "nonqualifying consideration" in connection with an exchange described in section 354 and 355. "Nonqualifying consideration" refers to any consideration received in the exchange other than "qualifying consideration," *i.e.*, other than stock or securities which may be received under section 354 or 355 without the recognition of gain or loss. Nonqualifying consideration, therefore, includes money, which is treated under the bill as having a fair market value and basis equal to its face amount.

Under the bill, section 356 is intended to apply even though, in the case of a qualified acquisition or a section 355 transaction, the shareholder or security holder exchanges stock or securities solely for nonqualifying consideration.

b. Amount of gain recognized—Under the bill, the shareholder or security holder shall recognize gain (if any) in the exchange equal to the fair market value of any nonqualifying consideration received. (In the case of securities, the fair market value of such property is defined as its issue price—see new section 366(i).)

c. Additional consideration received in certain distributions—The bill retains the current law rule that any nonqualifying consideration received in a distribution under section 355 shall be treated as a distribution of property to which section 301 applies.

d. No loss recognition—As under present law, the bill provides that in general, no loss from any section 354 or 355 transaction may be recognized. The bill permits an exception to the general rule, and loss (if any) shall be recognized in the case of a section 354 exchange, where a shareholder of the target corporation receives no stock of a party to the acquisition in exchange for his target stock, or where a security holder of the target corporation receives neither stock nor securities of a party to the acquisition in exchange for his target securities. Similarly, loss (if any) shall be recognized in the case of a section 355 exchange where a shareholder of the distributing corporation receives no stock of the controlled corporation in exchange for his distributing corporation stock, or where a security holder of the distributing corporation receives neither stock nor securities of the controlled corporation in exchange for his distributing corporation securities. Thus, for example, if in connection with a qualified acquisition, a target shareholder exchanges his target stock solely for cash, he shall recognize loss (if any) in the transaction.

e. Treatment of nonqualifying consideration as dividend—Under current law, if the receipt of nonqualifying consideration in a section 354 of 355 exchange has the effect of a distribution of a dividend, then each distributee is treated as having received a dividend, but in an amount limited by the lesser of (i) the gain recognized in the exchange, and (ii) his ratable share of earnings and profits of the distributing corporation. The remainder, if any, of the gain recognized in the exchange is treated as gain from the exchange of property.

Under the bill, where the receipt of nonqualifying consideration in a section 354 or 355 exchange has the effect of a dividend distribution (as described below), then neither gain nor loss shall be recognized but rather, the recipient shall be treated as having received a dividend equal to the lesser of (i) the fair market value of the nonqualifying consideration received; or (ii) the recipient's ratable share of earnings and profits of the target corporation and any party to the acquisition, the stock or securities of which were received by the recipient (or, in the case of an exchange under section 355, the earnings and profits of the distributing corporation and any controlled corporation, the stock or securities of which were received by the recipient). If only nonqualifying consideration is received, the earnings and profits to be counted include the recipient's ratable share of earnings and profits of the target and acquiring corporations. In making these determinations, earnings and profits are not to be double-counted.

As under present law, any excess gain recognized by the recipient over the amount treated as a dividend shall be treated as gain from the exchange of property.

f. Determination of whether exchange has effect of dividend—Under the bill, in the case of a section 354 exchange, determination of whether the exchange has the effect of a dividend distribution is made by assuming that the target shareholder exchanged his stock solely for stock of any party to the acquisition, and then had a portion of such stock redeemed (by the amount of nonqualifying consideration received) in a transaction to which section 302 applies. The amount of stock of a party to the acquisition deemed received shall be determined by grossing up, pro-rata by value, the stock of a party to the acquisition actually received. If only nonqualifying consideration is received, the target shareholder is treated as receiving solely stock of the acquiring corporation and then as being completely redeemed of the interest deemed received. Thus, the holding of *Shimberg* v *United States,* 577 F.2d 283 (5th Cir. 1978) is rejected and the holding of *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973) is codified.

For example, assume that P makes a qualified acquisition of T, and CP owns all of the stock of P. Assume that in the transaction, a T shareholder exchanges his stock for 100 shares of P (worth $1000), 100 shares of CP (worth $2000) and $3000 cash. In this case, for purposes of determining whether the cash distribution has the effect of a dividend, the T shareholder will be treated as having received 200 shares of P and 200 shares of CP in the transaction, followed by a redemption of 100 shares of each of P and CP.

In the case of a section 355 exchange, determination of whether the exchange has the effect of a dividend distribution would be made under section 302. Thus, the distribution will be treated as a dividend unless one of the tests in section 302(b) is satisfied.

In each case, as under present law, section 302 includes the application of the attribution rules in section 318.

g. Special rules for controlling corporate shareholders—Special rules are provided in the case of qualified acquisitions where there is a controlling corporate shareholder of the target corporation. In general, these rules are designed to avoid a second corporate level tax where the target corporation is acquired in a cost basis acquisition. In addition, where the target corporation is acquired in a carryover basis acquisition and all or part of the consideration is nonqualifying consideration, these rules are designed to insure that either the controlling corporate shareholder or a distributee of such shareholder will recognize gain (if any) on receipt of the nonqualifying consideration. Where the acquisition is part-cost basis and part-carryover basis, gain (if any) may be recognized by the controlling corporate shareholder, but generally limited to the gain attributable to the assets acquired in the carryover basis acquisition.

(i) General rule: cost basis acquisitions—Under the bill, in the case of a qualified acquisition of the target corporation for which a cost basis election is made, a controlling corporate shareholder of the target does not recognize gain or loss upon receipt of nonqualifying consideration. An exception applies, and gain (if any) shall be recognized by the controlling corporate shareholder, in any case where section 364(e) (relating to stock acquired in a qualified asset acquisition) or section 365(b)(2) (relating to carryover treatment of unamortizable property) applies. In that case, recognition of gain shall be limited to the lesser of (a) the net gain of the target corporation allocable to the assets treated as acquired in the carryover basis acquisition, or (b) the fair market value of the nonqualifying consideration received.

For example, assume that corporation A owns all of the stock of T, which has a wholly-owned subsidiary, S. Assume that P acquires all of the assets of T (including the S stock) for P stock and cash, and T distributes all of its assets, including all of the consideration received, to A. Finally, assume that the acquisition of S is a carryover basis acquisition, and the acquisition of T's assets (other than the S stock) is a cost basis acquisition. In this case, it is intended that A will recognize gain (if any) on the receipt of the cash, but limited to the lesser of (a) the gain attributable to the S assets and (b) the amount of cash received. (As explained below, A may be able to avoid recognition of gain if it distributes all of its assets within 12 months of the acquisition.)

Assume, in the above example, that T only owned 20 percent of the stock of S, and that P acquired the remaining 80 percent of S stock in a separate transaction but within one year of the acquisition of T. In that case, it is intended that gain (if any) of A will be limited to the lesser of (a) the gain attributable to T's pro-rata (*i.e.*, 20 percent) interest in the S assets (determined at the time of the acquisition) and (b) the amount of cash received.

If the target corporation is a foreign corporation, the general nonrecognition rule does not apply to the extent the income of the target corporation is not subject to tax under section 882.

(ii) General rule: carryover basis acquisitions—Under the bill, in the case of a qualified acquisition of the target corporation for which a cost basis election is not made, a controlling corporate shareholder of the target shall recognize gain (if any), but not loss, on the receipt of nonqualifying consideration unless the shareholder distributes all of its assets (other than assets retained to meet claims) within 12 months of the acquisition. Except as provided in regulations, section 332 shall not apply to any such distribution.

For example, assume that corporation A owns all of the stock of T, and P acquires all of the assets of T in a carryover basis acquisition in exchange for P stock and cash. T distributes all of its assets, including all of the consideration received, to A. In this case, A would recognize gain (but not loss) on the receipt of the cash. The gain recognition to A could be avoided if A, in turn, distributed all of its assets (other than assets retained to meet claims) within 12 months of the acquisition. In that case, except as provided in regulations, section 332 would not apply even though A, in turn, is owned by controlling corporate shareholder, Q. It is anticipated that regulations would permit section 332 to apply in the latter case on the condition that Q distributed all of its assets (other than assets retained to meet claims) within 12 months of the acquisition in a transaction to which section 332 does not apply.

In short, it is expected that the regulations would permit an optional chain liquidation. All distributions up the chain could be subject to section 332 so long as the ultimate distribution is not subject to section 332.

(iii) Section 332 not to apply—In general, subject to the above general rules, the tax treatment of any distribution to a controlling corporate shareholder of the target in connection with a qualified acquisition of the target shall be tested under section 354 and 356, and section 332 shall not apply.

(iv) Controlling corporate shareholder defined—A controlling corporate shareholder of the target corporation is any corporation which, before the acquisition date, owns stock representing control of the target corporation. It is anticipated that the step transaction doctrine will apply in determining whether control was owned before the acquisition date.

h. Exchanges for section 306 stock—Under current law, to the extent nonqualifying consideration is received in exchange for section 306 stock, an amount equal to the fair market value of the nonqualifying consideration is treated as a distribution of property under section 301. Under the bill, the amount treated as a section 301 distribution is equal to the lesser of (i) the fair market value of the nonqualifying consideration received or (ii) the recipient's ratable share of earnings and profits of the target corporation and any party to the acquisition, the stock or securities of which were received by the recipient (or, in the case of an exchange under section 355, the earnings and profits of the distributing corporation and any controlled corporation, the stock or securities of which were received by the recipient). For this purpose, earnings and profits are not to be double-counted. In the case of a section 354 exchange, the special rule does not apply where the target shareholder does not receive any qualifying consideration in the exchange. However, the general rules of section 306 may still apply to the disposition of section 306 by the target shareholder.

i. Other—Current law section 356(d) is repealed. The rules have been replaced by other provisions in other sections and subsections dealing with the treatment of securities. Current law section 356(f) is repealed as surplusage.

5. *Section 357*—Section 357 has been amended in the following respects:

a. General rule—Under current law, in the case of section 351 exchanges and reorganizations, an assumption of the transferor's liabilities by the transferee, or the acquisition from the transferor of property subject to a liability, is not treated as the receipt of boot by the transferor. Exceptions are provided in cases of tax avoidance and in certain cases where liabilities exceed basis. In contrast, under current law, the assumption of a liability or the acquisition of property subject to a liability in a section 1031 exchange is treated as boot.

Under the bill, in closer conformity with section 1031, the general rule under section 357 is limited to cases where the liability is "qualified indebtedness." "Qualified indebtedness" is defined as either (i) purchase money indebtedness, or (ii) any liability assumed or acquired by the transferee incident to the transferee's acquisition, holding, or operation in the ordinary course of business of the property transferred. The rule applies to exchanges described in section 351, 354, 355, or 356. Thus, the assumption or acquisition of a liability not described above would be treated as boot to the transferor.

The bill retains the current law exception for certain cases where qualified indebtedness exceeds basis in the case of a section 351 exchange. The bill repeals the tax avoidance exception.

6. *Section 358*—Under the bill, section 358 has been significantly modified to conform to the new rules relating to qualified acquisitions. Section 358 generally provides the basis rules for property received by shareholders or security holders of the target corporation in connection with a qualified acquisition. In addition, as under current law, section 358 provides the basis rules for property received by the transferor in a section 351 exchange, and by the distributee in a section 355 transaction.

a. Qualifying consideration—Under the bill, the basis of any qualifying consideration received in a section 351, 354, 355, or 356 exchange shall be equal to the basis of the property for which it was exchanged (i) decreased by the fair market value of any nonqualifying consideration received, and (ii) increased by (a) the amount which was treated as a dividend, plus (b) the amount of gain (if any) recognized by the recipient in such exchange (not including any portion of gain treated as a dividend), or recognizable by the recipient but for section 453.

In the case of an exchange under section 351, if the fair market value of the property transferred at the time of the exchange is less than the basis of the property transferred, the general rule shall be applied by substituting the fair market value for such basis.

b. Nonqualifying consideration—Under the bill the basis of any nonqualifying consideration received in a section 351, 354, 355, or

356 exchange shall be equal to the fair market value of the consideration received at the time of the exchange.

c. Special controlling corporate shareholder rules—Several special rules apply in the case of a controlling corporate shareholder of the target that receives qualifying consideration in the qualified acquisition. Where applicable, these rules override the general rule described above.

First, the basis of any qualifying consideration received by a controlling corporate shareholder in a qualified acquisition shall be equal to the lesser of the (i) basis of the stock or securities of the target corporation for which such consideration was exchanged, or (ii) the fair market value of the consideration at the time of the exchange.

Second, in the case of a transaction to which section 356(e)(1)(C) applies (relating to nonrecognition treatment to controlling corporate shareholders in certain circumstances), except as provided in regulations, the basis of any qualifying consideration received shall be the fair market value of the consideration received at the time of the exchange. It is anticipated that regulations will provide exceptions to this rule in cases where section 356(e)(1)(C) applies only in part (for example, as a result of section 356(e)(2)).

Third, in the case of a transaction to which section 364(g) applies (relating to certain recapitalizations, etc.), the basis of any qualifying consideration received shall be determined under the general rule, notwithstanding the fact that the fair market value of the consideration received at the time of the exchange is less than the basis of the stock or securities surrendered in the exchange.

d. Allocation of basis—The bill retains the current law rule providing regulatory authority for the allocation of the total basis of all qualifying consideration received among the specific stock and securities comprising the qualifying consideration. In addition, the bill retains the special current law rule for section 355, and repeals current law section 358(b)(3).

e. Section 355 distributions—The bill retains the current law rule treating a section 355 distribution as an exchange, for purposes of section 358.

f. Assumption of liability—The bill retains the current law rule treating an assumption of liability as nonqualifying consideration, for purposes of section 358.

g. Repeal—The bill repeals current law section 358(e).

7. *Section 361*—Under the bill, section 361 has been significantly modified to provide the corporate level tax consequences of all qualified acquisitions.

a. Carryover basis acquisitions—In the case of a qualified acquisition for which no cost basis election has been made, no gain or loss shall be recognized by the target corporation. As described below under section 364, in order to qualify as a qualified asset acquisition of the target corporation, the target must distribute all of its assets within 12 months of the acquisition. Thus, the current law rules providing for gain recognition in the case of a failure to distribute nonqualifying consideration are no longer needed and have been repealed.

b. Cost basis acquisition—In the case of a qualified stock acquisition for which a cost basis election has been made, the target corporation shall be deemed to have sold all of its assets at the close of the acquisition date in a transaction in which gain or loss is recognized, and then to be a new corporation which purchased all of such assets as of the beginning of the day after the acquisition date. The price for the purchase and sale of such assets is deemed to be their fair market value on the acquisition date. In general, "fair market value" may be determined by the purchase price for the stock, as adjusted for taxes and minority interests, or by appraisal of the assets, so long as the same method is used for purposes of both the deemed sale and the deemed purchase. Except as provided in regulations, any adjustment to basis of the assets deemed acquired shall be made on the basis of the relative fair market values of the assets.

In the case of a qualified asset acquisition for which a cost basis election has been made, the assets transferred shall be treated as sold or exchanged by the target corporation in a transaction in which gain or loss is recognized.

c. Target corporation that is member of affiliated group—In the case of a qualified stock acquisition or statutory merger or consolidation for which a cost basis election has been made, the target corporation generally shall not be treated as a member of an affiliated group with respect to any gain or loss recognized in the transaction.

Except as provided in regulations, an election to treat the target as part of the "selling consolidated group" with respect to the gain or loss recognized in the transaction may be made by the acquiring corporation and the common parent of the selling consolidated group. In addition, where there is more than one target corporation acquired by the acquiring corporation on the acquisition date and such target corporations were members of the same selling consolidated group, they may file a combined deemed sale return. For these purposes, the term "selling consolidated group" means any group of corporations which, for the taxable year of the group which includes the acquisition date, includes the target corporation and files a consolidated return.

d. Reverse triangular mergers—In the case of a reverse triangular merger which is treated as a qualified stock acquisition under new section 364(g), if a cost basis election is made, only the assets held by the surviving corporation immediately before the acquisition shall be treated as sold (and purchased) in the acquisition. Thus, for example, assume that corporation P owns all of the stock of corporation S, and that S merges into corporation T, with T surviving. In the merger, the T shareholders exchange their T stock for P stock, and P obtains control of T. Such merger is treated as a qualified stock acquisition of T by P and if a cost basis election is made, only the assets held by T immediately before the merger shall be treated as sold (and purchased) in the transaction. (As discussed below, the merger does *not* constitute a qualifed asset acquisition of S by T.)

8. *Section 362*—Under the bill, section 362 sets forth the basis rules to corporations in organization transactions and in qualified acquisitions.

a. Organization transactions—As under current law, a corporation which acquires property in connection with a section 351 transaction or as paid-in surplus or as a contribution to capital shall obtain a basis in such property equal to the transferor's basis, increased by any gain recognized to the transferor in the transfer.

For these purposes, the bill clarifies the amount of gain recognized by the transferor on receipt of a security. If the issue price of securities received by the transferor in the transaction exceeds the adjusted basis of securities surrendered, gain shall be recognized by the transferor. However, if the security received constitutes an installment obligation, section 453 will determine the amount and timing of the gain recognized to the transferor, and accordingly, the amount and timing of the basis of any property transferred to the transferee. *See* Prop. Reg. sec. 1.453-1(f). Where the property transferred is depreciable property, it is anticipated that any increase in the basis of such property to the transferee resulting from gain recognition to the transferor may be written off over the original ACRS period of the property. *See, e.g.,* Prop. Reg. section 1.453(f)(3)(iii), Eg. (2) and (3); Prop. Reg. section 1.168-2(d)(3). If the increase in basis occurs after the transferee has disposed of the property, it is expected that the transferee will be entitled to a loss deduction. *See* Prop. Reg. section 1.453-1(f)(3)(iii), Eg. (1).

b. Basis of acquiring corporation in qualified asset acquisition—An acquiring corporation (and any affiliated acquiring corporation) that acquires property in a qualified asset acquisition for which a cost basis election has not been made shall obtain a basis in such property equal to the target corporation's basis. If a cost basis election is made in such qualified asset acquisition, the basis of property acquired shall be determined under section 1012.

c. Basis of target corporation in qualified asset acquisition—The basis of any property (including qualifying consideration) received by a target corporation in a qualified asset acquisition shall be the fair market value of such property on the acquisition date.

d. Basis of acquiring corporation in qualified stock acquisition—For the basis of stock acquired by an acquiring corporation (and any affiliated acquiring corporation) in a qualified stock acquisition, see section 1020.

e. Special rule for certain contributions to capital—Except as provided in regulations, the present law rules relating to contributions to capital which are not made by a shareholder as such are retained.

9. *Section 364*—Under the bill, new section 364 provides rules defining qualified acquisitions.

a. Qualified acquisition—A "qualified acquisition" is any qualified stock acquisition or any qualified asset acquisition.

b. Qualified stock acquisition—A "qualified stock acquisition" is any transaction or series of transactions during the 12-month acquisition period in which one corporation acquires stock representing control of another corporation. It is intended that stock representing control must be acquired during the 12-month acquisition period for the transaction to constitute a qualified stock acquisition. Thus, for example, if corporation A previously owned 70 percent of the vote and value of corporation B and, during a 12-month period acquired an additional 10 percent of the vote and value of B (after which A owned stock representing control of B), such acquisition would not constitute a qualified stock acquisition of B. Accordingly, a cost basis election would not be available with respect to the assets of B. However, an acquisition of control by means of a stock acquisition in combination with a redemption or recapitalization may qualify as a qualified stock acquisition. *See, e.g. Madison Square Garden Corp.* v. *Commissioner,* 500 F.2d 611 (2d Cir. 1974).

c. Qualified asset acquisition—A "qualified asset acquisition" is (i) any statutory merger or consolidation, or (ii) any other transaction in which one corporation acquires at least 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets of another corporation held immediately before the acquisition, and the target corporation, within the 12-month period beginning on the acquisition date, distributes all its assets (other than assets retained to meet claims) to its shareholders and creditors.

It is intended that in determining what assets of the target corporation are held "immediately before the acquisition," prior dispositions of the target's assets shall be disregarded. Thus, the rule of *Helvering* v. *Elkhorn Coal Co.,* 95 F.2d 732 (4th Cir. 1937), *cert. denied* 305 U.S. 605 (1938), is rejected.

In contrast to the definition of a qualified stock acquisition, which specifically permits creeping acquisitions of stock during a 12-month period, a qualified asset acquisition requires an acquisition of assets in a single transaction, Thus, in general, a creeping acquisition of assets will not qualify as a qualified asset acquisition. It is anticipated, however, that in unusual cases, a closing of a single acquisition may extend over several days. If it is clear that all of the activities during the several-day period relate to the same transaction, the transaction may qualify as a qualified asset acquisition. In that case, the "acquisition date" shall be the last date of the closing.

The bill clarifies that the required distribution of all of the target's assets (other than assets retained to meet claims) may be made to either target shareholders or creditors. Therefore, the bill overrules *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609 (1938). If the required distribution is not made within the 12-month period beginning on the acquisition date, the transaction will not qualify as a qualified asset acquisition, but rather will be a taxable transaction to all parties. In addition, any stock of a party to the acquisition will not qualify as qualifying consideration to the target shareholders. (See section 365(d)(2) for a possible exception involving transactions between related parties.)

The required distribution of assets need not be of assets held by the target corporation at the time of the acquisition. Hence, interim sales of target assets, including any retained assets and any consideration (including qualifying consideration) received in the acquisition, after the acquisition and prior to the required distribution will not affect the distribution requirement.

Where the acquisition consists of both a qualified asset acquisiton of the target corporation and a qualified stock acquisition of a subsidiary of the target corporation, the distribution requirement will apply to all assets of the target, including any consideration received for the stock of the subsidiary. For example, assume that T owns certain operating assets as well as all of the stock of S. P acquires all of T's assets, including its S stock, for P stock and cash.

Under new section 364(e) (described below), the transaction constitutes both a qualified stock acquisition of S and a qualified asset acquisition of all of T's assets other than its S stock. The required distribution by T would require T to distribute all of its assets, including all of the P stock and cash received in the acquisition or any proceeds from any interim sales of such consideration, to T's shareholders or creditors within 12 months of the acquisition. Failure to make such distribution would make the entire transaction taxable.

In general, except as provided in regulations, a distribution by a corporation of assets or stock held by it to another corporation (whether or not by liquidation) shall not constitute a qualified asset acquisition or qualified stock acquisition.

d. Deemed stock acquisition—If, as a result of a qualified stock acquisition of one corporation, an acquiring corporation is treated under section 318(a) as owning stock of another corporation, the acquiring corporation shall be treated as having acquired such stock of the other corporation on the acquisition date of the qualified stock acquisition, for purposes of determining whether the acquiring corporation has made a qualified stock acquisition of the other corporation. For example, assume P acquires 100 percent of the stock of T on July 1, 1986, and T owns 50 percent of the stock of S. As a result of the qualified stock acquisition of T, P is treated as having acquired T's 50 percent interest in S on July 1, 1986, for purposes of determining whether P has made a qualified stock acquisition of S. If, within the 12-month period beginning on July 1, 1986, P acquires an additional interest in S stock sufficient to obtain control of S, P will have made a qualified stock acquisition of S.

The look-through rule applies only if there has been a qualified stock acquisition of the first corporation. Thus, in the above example, if P had acquired only 50 percent of the stock of T, then P would not be deemed to have acquired one-half of any stock owned by T.

For purposes of this rule, section 318(a)(4) (option attribution) shall not apply, and, in applying section 318(a)(2)(C), a corporation owning control of another corporation shall be treated as owning all of the stock of such other corporation.

For example, assume T owns 80 percent of the vote and value of S, and P acquires 80 percent of the vote and value of T. In applying section 318(a)(2)(C), which attributes the ownership of T's stock in S to P, P shall be treated as owning all of the stock of T. Therefore, under section 318(a)(2)(C), P shall be deemed to have acquired 80 percent of the vote and value of S, *i.e.,* P is deemed to have made a qualified stock acquisition of S.

e. Overlap—The bill clarifies that if an acquiring corporation acquires stock of another corporation in a qualified asset acquisition (taking into account the stock) and the stock acquisition is, or is part of, a qualified stock acquisition by the acquiring corporation, then the acquiring corporation is treated as having acquired the stock in a qualified stock acquisition, and the assets (other than the stock) in a separate qualified asset acquisition.

For example, assume that T owns certain operating assets and all of the stock of S. P acquires most of the T operating assets as well as all of T's stock in S. If P has made a qualified asset acquisition of T (determined by taking into account the S stock), then P shall be treated as having made both (i) a qualified stock acquisition of S, and (ii) a qualified asset acquisition of T (other than the stock of S). P would be entitled to make separate elections for each of the two qualified acquisitions. In this example, if T were a pure holding company whose sole asset consisted of the stock of S, P would be treated as having made a qualified stock acquisition of S and not a qualified asset acquisition of T. (But see section 354(c) which provides a special rule for purposes of section 354.)

Assume instead that T owns operating assets and stock consisting of only 20 percent of the vote and value of S. Assume that P acquires all of T's assets, including its stock of S. If, within 12 months of the acquisition, P were to acquire a sufficient additional interest in S stock to obtain control of S, then the transactions would be treated as (i) a qualified stock acquisition of S and (ii) a qualified asset acquisition of T (other than its stock in S). If P did not acquire the additional interest in S during such 12 months, then the transaction would be treated as a qualified asset acquisition of T (including T's stock in S).

In determining whether a qualified asset acquisition has been made, stock held by the target corporation shall not be taken into account if the acquiring corporation also makes a qualified asset acquisition of the corporation whose stock is owned by the target corporation. For example, assume that T owns all of the stock of S, P makes a qualified asset acquisition of S, and P acquires certain of the T assets (but not the S stock held by T). Ordinarily, in determining whether P has made a qualified asset acquisition of T, the stock of S must be taken into account. However, because P has also made a qualified asset acquisition of S, the stock of S held by T is disregarded.

f. Reverse Triangular Mergers—In the case of a merger where former shareholders of the surviving corporation sell or exchange stock in the surviving corporation, and a corporation in control of the merged corporation before the merger is in control of the surviving corporation after the merger, the merger shall be treated as an acquisition of the stock of the former shareholders of the surviving corporation by the controlling corporation. For example, assume that P owns all of the stock of S and S is merged into T. In the transaction, the former shareholders of T exchange their T stock for P stock, after which P owns all of the stock of T. The transaction is treated as a stock acquisition of T by P and, because P obtained stock constituting control of T in the merger, it is a qualified stock acquisition of T. If, prior to the merger, P owned 40 percent of the T stock and obtained the other 60 percent in the merger, the transaction would constitute a stock acquisition of the T stock by P, but not a qualified stock acquisition. (If the merger took place within 12 months of P's purchase of the 40 percent interest in T, the transaction would be a qualified stock acquisition.) In all of the above cases, the transaction would *not* constitute a qualified asset acquisition of S by T.

g. Recapitalizations, changes in identity, etc.—A transaction qualifying under current law as an "E" Reorganization (a recapitalization) is treated under the bill as a qualified stock acquisition, with the recapitalized corporation being treated as both the target and acquiring corporations. As described below, no cost basis election may be made in the case of a recapitalization. Thus, the only effect of treating a recapitalization as a qualified stock acquisition is to insure that the tax treatment of the exchanging shareholders and security holders of the recapitalized corporation is determined under sections 354, 356, and 358. The stock and securities of the recapitalized corporation that is exchanged in the transaction is treated as stock and securities of the target corporation, and the stock, securities and other consideration that is received in the transaction is treated as consideration of the acquiring corporation.

An "F" Reorganization under current law (a mere change in identity, form, or place of organization of one corporation, however effected) is treated under the bill as a qualified asset acquisition, with the corporation being treated as both the target and acquiring corporations. As described below, a cost basis election may not be made in this type of transaction either. Thus, the only effect of treating an "F" reorganization as a qualified asset acquisition is also to insure that the tax treatment of the transaction to the shareholders is determined under sections 354, 356, and 358.

h. Title 11 or similar cases—Two special rules are provided in the case of a target corporation involved in a Title 11 or similar case. First, the Secretary is authorized to extend by regulations the 12-month period during which the required distribution by the target corporation in a qualified asset acquisition must take place.

Second, a reverse triangular merger will not be treated as a qualified stock acquisition if no former shareholders of the surviving corporation receive consideration in the merger in exchange for their stock. Such a transaction will, however, be treated as a reverse merger, subject to the rules prescribed under section 366(e).

10. *Section 365*—Under the bill, new section 365 provides rules defining carryover basis acquisitions and cost basis acquisitions.

a. Carryover basis acquisitions—In general, a carryover basis acquisition is any qualified acquisition with respect to which no cost basis election is made. Thus, all qualified acquisitions are presumptively carryover basis acquisitions unless a contrary election is made.

b. Cost basis acquisitions—In general, a cost basis acquisition is any qualified acquisition with respect to which a cost basis election is made.

c. Special rule for intangibles—Notwithstanding a cost basis election and the consistency rules (described below), a carryover basis election may be made with respect to any unamortizable intangible acquired in a qualified acquisition. For this purpose, "unamortizable intangible" refers to any intangible property which (i) is of a character not subject to depreciation or amortization under section 167 and (ii) is goodwill or similar type property designated in regulations. Intangible property will generally be considered of a character not subject to depreciation or amortization if the target corporation has never depreciated or amortized it, and the acquiring corporation agrees never to depreciate or amortize it. It is expected that Treasury regulations will place conditions as to the availability of this election to insure the foregoing. In addition, it is expected that Treasury regulations will require the acquiring and target corporations to agree upon the fair market value of the intangible property, which will be binding on the taxpayers but not upon the IRS. No such election may be made with respect to property described in section 1031(a)(2) or 1221(1).

For example, assume all of the assets of T are acquired by P in a qualified asset acquisition and a cost basis election is made. Despite the consistency requirement, an election may be made to treat the target's goodwill as having been acquired in a carryover basis acquisition. Accordingly, the target corporation will not recognize any gain or loss on the transfer of the goodwill, and the acquiring corporation will obtain a carryover basis in such property.

d. Party who must make election—In general, the acquiring corporation must make the cost basis election as well as the election relating to intangibles. In the case of a qualified asset acquisition other than a statutory merger or consolidation, any such election must also be made by the target corporation.

e. Consistency rules—In general, the consistency rules are designed to require that, in the case of a qualified acquisition of the target corporation, any asset acquired by the acquiring corporation during the consistency period (generally, the one year periods immediately prior to and immediately after the qualified acquisition) must be treated consistently with the qualified acquisition (*i.e.*, both carryover or both cost basis acquisitions) if such asset and one or more other assets acquired in the qualified acquisition were held by the same corporation at any one time during the consistency period. Failure to treat such assets consistently shall result in mandatory cost basis treatment for all such assets with respect to the target and acquiring corporations.

For these purposes, an acquiring corporation in a qualified stock acquisition is treated as having acquired the assets of the target corporation. In addition, for these purposes, any acquisition during the consistency period by a member of an affiliated group of which the acquiring corporation is a member shall be treated as made by the acquiring corporation.

For example, assume that P acquires asset X from T in a taxable transaction. Within one year, P makes a qualified asset acquisition of T and no cost basis election is made. In this situation, absent any exceptions applying, the qualified asset acquisition will be treated as a cost basis acquisition with respect to both P and T.

Assume, instead, that after P acquires X from T in a taxable transaction, T drops its other assets into wholly-owned subsidiary S, and P makes a qualified stock acquisition of S within one year of its acquisition of X. Assume no cost basis election is made with respect to the qualified stock acquisition. For purposes of the consistency rules, P is treated as having acquired the assets of S at the time of the qualified stock acquisition of S. Therefore, the consistency rules apply and, absent any exceptions applying, the qualified stock acquisition of S will be treated as a cost basis transaction.

The same result applies in each of the above examples if one of the acquisitions was made by P and the other acquisition was made by an affiliate of P.

An exception to the general rule is permitted if the acquiring corporation elects to treat all of the assets acquired as having been acquired in a carryover basis acquisition. In that case, the transferor of any such assets in a cost basis transaction would still be required to recognize gain or loss. It is anticipated that regulations will prohibit or provide conditions to this election where a carryover basis to the acquiring corporation would be greater than cost basis.

Exceptions to the general rule are also provided (i) where any assets not acquired in the qualified acquisition were acquired pursuant to a sale by any person in the ordinary course of its trade or business, or (ii) under circumstances described in regulations.

A special rule applies if a cost basis election was not permitted with respect to the qualified acquisition because of section 365(d) (regarding transactions between related parties), described below. In that case, except as provided in regulations, the asset not acquired as part of the qualified acquisition will be treated as having been a part of that acquisition. Accordingly, except as provided in regulations, all of the assets acquired will be treated as having been acquired in a carryover basis acquisition. In general, it is anticipated that regulations will preclude or limit this result where a carryover basis to the acquiring corporation would be greater than a cost basis with respect to the asset not acquired in the qualified acquisition. In addition, regulations should consider whether the transferor of such asset should nevertheless recognize gain or loss in the transaction.

Finally, for these purposes, the term "asset" shall not include stock which is acquired as part of a qualified stock acquisition.

The operation of the consistency rules is illustrated by the following examples. In each example, it should be assumed that none of the exceptions to the general rule applies unless stated otherwise. Abbreviations used include: qualified asset acquisition ("QAA"), qualified stock acquisition ("QSA"), and target shareholder ("T-SH").

(i) P acquires asset X from T in a taxable transaction. Within one year, P makes a QAA or QSA of T and no cost basis election is made. Result: the QAA or QSA is treated as a cost basis acquisition.

(ii) Same as (i) except that P makes a QAA of T first, followed within one year (and prior to any distribution by T of all of its assets) by the taxable acquisition of asset X from T. Same result as (i).

(iii) Same as (ii) except that asset X was acquired by T after the QAA of T, or X was part of the original consideration P paid to T in the QAA of T. Result: consistency rules do not apply here. Asset X and the assets acquired in the QAA were not held by the same corporation at any one time during the consistency period.

(iv) Same as (ii) except that within one year of the QAA of T, T distributes X to T-SH and P acquires X from T-SH in a taxable transaction. Same result as (i).

(v) T distributes asset X to individual A. Within one year, P makes a QAA or QSA of T and does not elect cost basis. Within one year thereafter, P acquires X from A in a taxable transaction. Result: the QAA or QSA is treated as a cost basis acquisition.

(vi) Same as (v) except that within one year of the acquisition of T, A drops X into corporation S which is acquired by P in a QSA and no cost basis election is made. Result: consistent treatment, therefore no change to the results.

(vii) Same as (vi) except that the T acquisition had a cost basis election, and the S acquisition had no cost basis election. Result: the QSA of S is a cost basis acquisition.

(viii) T drops asset X into subsidiary A, asset Y into subsidiary B. Within one year, P makes a QSA of A (elects cost) and a QSA of B (no cost basis elected). Result: the QSA of B will be treated as a cost basis acquisition.

(ix) Same as (viii) except that the QSA of A and B take place 18 months after the dropdowns. Result: The consistency rule does not apply because assets X and Y were not held by a single corporation during the consistency period with respect to either the QSA of A or B.

(x) Same as (ix) except that the QSA of A takes place within one year of the dropdowns and the QSA of B takes place within one year of the QSA of A. Result: The consistency rule applies. During the consistency period for the QSA of A, X and Y were held by a single coporation, and P acquired X and Y. Therefore, the QSA of B will be treated as a cost basis acquisition.

(xii) T owns all the stock of S, as well as other assets. P makes a QSA of S. Within one year, P makes a QAA or QSA of T. Result: absent other facts (such as a dropdown of an asset from T to S within one year of the QSA of S), the consistency rule does not apply. The stock of S held by T is not considered an "asset" for purposes of determining whether P acquired assets that were not treated consistently.

(xiii) Same as (i) except that an election is made under regulations to treat X as having been acquired in a carryover basis acquisition. Result: assuming the regulations are complied with, the consistency rules will not apply, and the QAA or QSA of T will still be a carryover basis acquisition. T, in any event, will still recognize gain or loss on the transfer of X to P.

(xiv) Same as (i) except that X was acquired from T in the ordinary course of business. Result: the consistency rules will not apply, and the QAA or QSA of T will still be a carryover basis acquisition.

(xv) A owns over 50 percent of the vote and value of each of T and P. P acquires asset X from T in a taxable transaction. Within one year, P makes a QAA or QSA of T and elects cost basis. Result: no cost basis election is permitted with respect to the QAA or QSA of T because P and T are related parties. The acquisition of X in a taxable transaction is therefore inconsistent with the QAA or QSA of T. Except as provided in regulations, X will be treated as having been acquired in a carryover basis transaction also.

f. Related Party Limitations—Under the bill, no cost basis election may be made with respect to any qualified acquisition if one or more persons in control of the acquiring corporation immediately after the acquisition date were in control of the target corporation immediately before the acquisition date (or, in the case of a qualified stock acquisition, immediately before the 12-month acquisition period).

In determining whether control of the target corporation existed immediately before the acquisition date of a qualified asset acquisition, stock of the target that was acquired from unrelated parties during the 12-month period prior to such date shall be disregarded. For example, assume corporation P acquires 60 percent of the vote and value of T from unrelated A. Within one year of the stock acquisition, T is merged into S, P's wholly-owned subsidiary, with the minority shareholders of T receiving P stock and cash. The merger is a qualified asset acquisition of T and because the T stock was acquired from an unrelated party within one year of the merger, such stock is disregarded for purposes of determining whether P controlled T immediately prior to the merger. Therefore, the related party limitations do not apply.

For this purpose, a person is unrelated to an acquiring corporation if (i) neither the person nor the corporation owns (or is treated as owning) stock representing control of the other, and (ii) no other person owns (or is treated as owning) stock representing control of both such person and the acquiring corporation.

Solely for purposes of determining the basis of the transferee in any property transferred, in applying the related party limitation, the term "qualified acquisition" shall (i) disregard the requirement in section 364(c)(2) that the target corporation must distribute all of its assets within 12 months of the acquisition, and (ii) include any transaction in which one corporation acquires "substantially all" of the assets of another corporation held immediately before the acquisition.

It is intended that relaxation of the distribution requirement and use of the term "substantially all" rather than the strict "70 percent of the gross fair market value/90 percent of the net fair market value" test will permit greater flexibility in determining whether a qualified asset acquisition has occurred for this purpose. *See, e.g., Smothers Company* v. *United States,* 642 F.2d 894 (5th Cir. 1981).

For example, assume A owns 50 percent of the vote and value of each of corporations T and P. T transfers substantially all of its assets to P in exchange for P stock and cash, and T does not distribute all of its assets within 12 months of the acquisition. Because the distribution requirement has not been satisfied, the transaction generally does not qualify as a qualified asset acquisition and, therefore, it is a taxable transaction to T and P. Furthermore, the P stock does not constitute qualifying consideration to T or T's shareholders. However, because the transaction constitutes a qualified acquisition in applying the related party limitations, P obtains a carryover basis in the assets acquired from T. The same result occurs even though the assets transferred constituted less than 70 percent of the gross fair market value or less than 90 percent of the net fair market value of the assets of T, so long as the "substantially all" test is satisfied. (If the transaction would result in a loss to T, section 267 may apply to disallow the loss.)

For purposes of the related party rules, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, *or* at least 50 percent of the total value of all classes of stock. In addition, the attribution rules under section 318 shall apply in determining control, except that (i) no option attribution is permitted, (ii) sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied by substituting "5 percent" for "50 percent", and (iii) a pro-rata rule shall apply in section 318(a)(3)(C).

g. Recapitalizations, Changes of Identity, etc—Under the bill, no cost basis election may be made with respect to any transaction qualifying as either an "E" or "F" Reorganization under current law.

h. Mandatory cost basis transactions—Under the bill, in the case of any qualified asset acquisition, if the acquiring or affiliated acquiring corporation is a tax-exempt entity, a regulated investment company (as defined in section 851(a)), or a foreign corporation, a cost basis election shall be deemed to have been made with respect to such acquisition. The rule would not apply to the extent the assets acquired constitute property described in section 168(j)(3)(D) (relating to property used in an unrelated trade or business) or section 168(j)(4)(B)(i) (relating to property subject to U.S. tax). The rule would also not apply where the target corporation is the same type entity as the acquiring or affiliated acquiring corporation. In the case of a regulated investment company, the rule would apply only where such company maintained that status after the acquisition.

In cases where this rule applies, it would override section 365(d) (relating to related party acquisitions).

i. Method of election—Any cost basis election and any election relating to unamortizable intangibles must be made before the later of (i) the 15th day of the 9th month following the month in which the acquisition date occurs, or (ii) the date prescribed in regulations. Any such election is irrevocable. In the case of any qualified stock acquisition, notice of the election must be given by the acquiring corporation to any corporate shareholder of the target corporation which owned stock representing control of the target immediately before the 12-month acquisition period.

11. *Section 366*—Under the bill, section 366 provides other definitions and special rules which are generally applicable to Part III of Subchapter C.

a. 12-month acquisition period—The term "12-month acquisition period" means, with respect to any qualified stock acquisition, the 12-month period beginning with the date of the first acquisition of stock included in the transaction or series of transactions involved in the qualified stock acquisition.

For example, if P acquires 50 percent of T on June 1, 1986 and the other 50 percent on December 1, 1986, the 12-month acquisition period is the 12-month period beginning with June 1, 1986, and the transactions constitute a qualified stock acquisition. If P were to acquire 10 percent of T on the first day of each of the seven months, January through July, 1986, and the remaining 30 percent of T on January 1, 1987, the 12-month acquisition period would not be the 12-month period beginning with January 1, 1986 because during that period, P would not have acquired control of T. The 12-month period beginning with February 1, 1986 would, however, be a 12-month acquisition period, and the transactions during that period would constitute a qualified stock acquisition.

b. Acquisition date—The term "acquisition date" means, with respect to any target corporation, the first day on which there is a qualified stock acquisition of the target or, in the case of a qualified asset acquisition, the date on which the acquiring corporation acquires the assets of the target. In the case of the two qualified stock acquisitions described above, the acquisition date would be December 1, 1986 and January 1, 1987, respectively. In the unusual case where the closing of a qualified asset acquisition extends over a several-day period, the acquisition date shall be the last date of such period.

c. Affiliated group—The term "affiliated group" has the same meaning given to such term by section 1504(a), but determined without regard to section 1504(b).

d. Consistency period—The term "consistency period" means, with respect to any qualified stock acquisition, the one-year period prior to the beginning of the 12-month acquisition period, plus that portion of the 12-month acquisition period ending with the acquisition date, plus the one-year period following the acquisition date. For example, if P acquires 50 percent of the stock of T on June 1, 1986 and the other 50 percent on December 1, 1986, the consistency period means the period from June 1, 1985 through December 2, 1987.

In the case of a qualified asset acquisition, the term "consistency period" means the one-year period ending before the acquisition date, the acquisition date, and the one-year period beginning on the day after the acquisition date.

e. Acquisitions by affiliates of acquiring corporation—Except as provided in regulations, an acquisition of stock or assets of the target corporation by more than one member of an affiliated group shall be treated as an acquisition by one corporation, for purposes of determining whether there is a qualified acquisition and for such other purposes that may be specified in regulations. For example, if P and its wholly-owned subsidiary S each acquires 50 percent of the stock of T, the transaction constitutes a qualified stock acquisition of T. If each acquires 50 percent of the assets of T, and T distributes all of its assets within 12 months of the acquisition, the transaction constitutes a qualified asset acquisition of T.

f. Acquiring, Target, and Affiliated Acquiring Corporations—In general, the "acquiring corporation" is any corporation which makes a qualified acquisition of another corporation. Where more than one member of an affiliated group acquires stock or assets of the target corporation in the qualified acquisition, the "acquiring corporation" is generally the "common parent" of such group. An exception to the above applies where one member of the group other than the common parent makes a qualified acquisition of the target (determined without regard to acquisitions by other members of such group), in which case such member shall be treated as the acquiring corporation. The secretary may provide additional exceptions in regulations.

The "target corporation" means any corporation the stock or assets of which are acquired in a qualified acquisition.

The term "affiliated acquiring corporation" means any corporation which is a member of an affiliated group and which acquired stock or assets in a qualified acquisition but is not treated as the acquiring corporation.

The term "common parent" has the same meaning as under section 1504(a), but without regard to section 1504(b).

These terms may be illustrated by the following example. Assume that corporation A owns all of the stock of both corporations B and C. B and C each acquired 50 percent of the stock of corporation D. In this case, A (the common parent of the affiliated group composed of A, B, and C) is the acquiring corporation, B and C are each affiliated acquiring corporations, and D is the target corporation. The result would be the same even if A were a foreign corporation, and therefore not an "includible corporation" by reason of section 1504(b)(3). If, instead of the above, B acquired 80 percent of the vote and value of D, and C only acquired the remaining 20 percent, B would be the acquiring corporation and C would be the only affiliated acquiring corporation.

g. Control—The term "control" means the ownership of stock in a corporation which meets the requirements of section 1504(a)(2) of the Code. For this purpose, sections 1504(a) (4) and (5) shall be taken into account.

h. Party to the acquisition—The term "party to the acquisition" means, with respect to any qualified acquisition, (i) the acquiring corporation and (ii) in the case of an acquiring corporation which is a member of an affiliated group, the common parent of such group and any other member of such group specified in regulations.

In general, where the acquiring corporation is a member of an affiliated group, it is intended that in addition to the acquiring corporation and the common parent of such group, any corporation which is a member of such group, and which owns control of the acquiring corporation, should qualify as a "party to the acquisition." Thus, for example, assume A owns 100 percent of B, B owns 100 percent of C, and C owns 100 percent of D. If C is the acquiring corporation, then A, B, and C, but not D, each qualifies as a party to the acquisition. If, however, A owns 100 percent of each of B and C, and B and C each owns 50 percent of D, and D is the acquiring corporation, the regulations should provide that only A and D qualify as a party to the acquisition.

i. Reverse acquisitions—Regulatory authority is provided to prescribe the appropriate rules in the case of a reverse acquisition, *i.e.,* any qualified acquisition after which shareholders of the target corporation own, as a result of owning stock in the target corporation, stock representing control of the acquiring corporation. For these purposes, "control" has the same meaning as in section 1504(a)(2) except that "50 percent" is substituted for "80 percent."

In general, it is intended that in a reverse acquisition, the nominal target corporation shall be treated as the acquiring corporation and the nominal acquiring corporation shall be treated as the target corporation. Thus, for example, if A merges into B, with B surviving, and in the merger, the former shareholders of A obtain 90 percent of the stock of B, the transaction should generally be viewed as an acquisition by A of the assets of B. Accordingly, a cost basis election made in the transaction should apply only to the premerger assets of B, and not to the assets of A.

j. Qualifying and nonqualifying consideration—The term "qualifying consideration" means property which is received in an exchange without recognition of gain by reason of section 351, 354, 355, 356, or 361, as the case may be. The term "nonqualifying consideration" means property (including money) received in an exchange to which section 351, 354, 355, 356, or 361, as the case may be, applies other than qualifying consideration. In the case of securities, "nonqualifying consideration" includes the excess of the issue price of securities received over the adjusted basis of securities surrendered.

k. Controlling corporate shareholder—The term "controlling corporate shareholder" means a corporation which owns stock representing control of another corporation.

l. Title 11 or similar case—The term "Title 11 or similar case" has the same meaning as under current law section 368(a)(3)(A).

m. Fair market value of securities—The fair market value of any security shall be equal to its issue price, determined under section 1273(b) and 1274(a).

n. Regulations—The Secretary is authorized to prescribe regulations as may be necessary or appropriate to carry out the purposes of Part III of Subchapter C including, but not limited to, regulations which treat warrants, obligations convertible into stock, and similar interests as stock, and stock as not stock, and which treat options to acquire or sell stock as having been exercised. In general, it is anticipated that any regulations treating certain such interests as stock, and stock as not stock, and treating options as having been exercised, will have prospective effect only.

12. *Section 367*—Other than conforming changes, the bill does not amend current law section 367.

13. *Section 368*—Under the bill, current law section 368 is repealed.

14. *Effective Date*—The amendments made by section 101 of the bill shall apply to transactions occurring after December 31, 1985, in taxable years ending after that date.

## SECTION 111—CORPORATE RECOGNITION OF GAIN OR LOSS ON DISTRIBUTIONS OF PROPERTY BY CORPORATIONS

15. *Section 311*—Under the bill, section 311 is significantly modified. In general, new section 311 determines the tax treatment of a corporation that makes a liquidating or nonliquidating distribution of property with respect to its stock.

a. General rule—In general, gain shall be recognized to a corporation on the distribution of property with respect to its stock. Loss shall also be recognized by the distributing corporation but only if the distribution is pursuant to a plan of complete liquidation.

Gain or loss shall be determined in the same manner as if the property distributed had been sold to the distributee at its fair market value.

b. Exception—The general rule shall not apply, and gain or loss shall not be recognized, in the following circumstances: (i) where the distributee's basis in the property distributed is determined under section 334(b); (ii) where the distribution consists of stock of a controlled corporation and the distribution qualifies as a transaction to which section 355 applies; and (iii) where the distribution consists of stock of a corporation of which the distributing corporation owned control during the 5-year period immediately preceding the distribution, and during such 5-year period, the controlled corporation did not receive from the distributing corporation a substantial part of its assets in a transaction to which section 351 applies or as a contribution to capital.

c. Effective Date—The amendments made to section 311 apply to distributions made after December 31, 1985, in taxable years ending after such date.

### SECTION 121—REPEAL OF SECTIONS 336, 337, 338, AND 341

16. *Repeals*—Under the bill, sections 336, 337, 338, and 341 of current law are repealed.

### SECTION 122—MODIFICATION OF SECTION 333 ELECTION

17. *Section 333*—Under current law, section 333 provides for the elective nonrecognition of gain for certain shareholders in certain liquidations of domestic corporations. In general, the liquidation must take place within one month, certain corporate shareholders are not eligible to make the election, and gain must be recognized (and, in the case of noncorporate shareholders, treated as a dividend) to the extent of the shareholder's ratable share of the earnings and profits of the liquidating corporation. Gain must also be recognized to the extent the money, stock or securities received by the shareholder exceeds his ratable share of earnings and profits. Finally, the shareholder's basis in any property distributed in the section 333 liquidation is the same as the basis of the shareholder's stock in the corporation, decreased by the amount of money received, and increased by the amount of gain recognized by him (section 334(c)).

Under the bill, section 333 is modified and simplified. In the case of a complete liquidation of any domestic corporation, nonrecognition of gain may be elected by a shareholder except to the extent of any money or property described in section 1031(a)(2)(B)–(E) (relating generally to stocks, bonds, notes, other securities, interests in partnerships, or certificates of trust or beneficial interests) received by the shareholder in the liquidation.

The provision may be elected by any shareholder who elects not to have section 1060 (relating to basis adjustments in the case of the liquidation or acquisition of certain small business corporations) apply to his stock. As under current law, a shareholder electing section 333 treatment obtains a basis in any property distributed equal to the shareholder's basis in the stock of the liquidating corporation, decreased by the amount of any money received, and increased by the amount of gain recognized by him.

### SECTION 123—EFFECTIVE DATES

18. *Effective Dates*—The amendments made to sections 333, 336, and 337 shall apply to liquidations made pursuant to plans of liquidations adopted after December 31, 1985.

The amendments made to section 338 shall apply to acquisitions made after December 31, 1985, except that such amendment shall not apply to qualified stock purchases (as defined in section 338(d)(3) of the Internal Revenue Code of 1954) where the acquisition date (as defined in section 338(h)(2) of such Code) is before January 1, 1987.

The amendment made to section 341 shall apply to sales, exchanges, and distributions made after December 31, 1985.

## SECTION 201—BASIS OF CONTROLLING CORPORATE SHAREHOLDER IN SUBSIDIARY

19. *Section 1020*—Under current law, except in the case of corporations filing a consolidated return, there is no requirement that the basis of a controlling corporate shareholder in the stock of a controlled subsidiary be conformed to the subsidiary's basis in its assets.

a. General rule—Under section 1020 of the bill, the basis of a controlling corporate shareholder in the stock of a controlled subsidiary is generally equal to the "applicable percentage" of the "net inside basis" of the assets of the subsidiary. The "net inside basis" is defined as the aggregate adjusted basis of the subsidiary's assets less the aggregate adjusted issue prices of the subsidiary's liabilities. For this purpose, the term "liabilities" does not include liabilities described in section 357(b)(2)(B). The term "applicable percentage" refers to the percentage of stock (by value) of the controlled subsidiary owned by the corporate shareholder. A minority shareholder's basis in the stock of the subsidiary is unaffected by these rules.

For example, assume that corporation P owns 80% of corporation S. Assume that corporation M owns the remaining interest in S. If the net inside basis of the assets of S is $100, then P's basis in its S stock is $80, subject to any adjustment for premium and discount accounts described below. M's basis in its S stock is not affected by section 1020.

Assume, instead, that corporation P owns 100% of corporation S, and corporation S owns 100% of corporation T. Assume that the net inside basis of S's assets other than its stock in T is $100. Assume also that the net inside basis of T's assets is $80. In this case, S's basis in its stock in T is equal to $80, subject to adjustment for the premium and discount accounts. S's net inside for its assets, including the T stock, is therefore $180. P's basis in the stock of S is also $180, subject to adjustments described below.

b. Premium and discount accounts—During generally the three taxable years immediately following the "control date" (*i.e.*, the date control was acquired or, if later, January 1, 1986), the controlling corporation shareholder's basis in the stock of its controlled corporation must be increased by any amount in the "premium" account, and decreased by any amount in the "discount" account. The initial amount in the premium and discount accounts is the amount by which the controlling corporate shareholder's basis in the stock of the subsidiary (determined without regard to section 1020) as of the control date is greater or less than the applicable percentage of the net inside basis of the subsidiary as of that date. No accounts need be established, and no adjustments need be made, where control is acquired in a qualified stock acquisition for which a cost basis election is made.

For example, assume that on July 1, 1986, corporation P purchases all of the stock of corporation S for $100, and no cost basis election is made. Assume that on that date, the net inside basis of the assets of the corporation was $50. The initial premium account would be $50. If P were to sell all of the stock of S the next day, P's basis in the stock of S would be the net inside basis of the S assets ($50) plus the amount in the premium account ($50) or $100. If P initially paid only $25 for the S stock, the initial discount account would be $25.

During the period the accounts must be maintained, adjustments must be made to the accounts for gains and losses recognized by the subsidiary. In general, the applicable percentage of any gain recognized by the subsidiary increases the discount account and decreases the premium account. An exception applies to the extent the controlling corporate shareholder establishes that the gain is allocable to periods after the control date. Any reduction of the premium account below zero shall be credited to the discount account.

For example, assume that on July 1, 1986, P purchases all of the stock of S for $1000 and no cost basis election is made. Assume that S's net inside basis as of that date was $500. The initial premium account is therefore $500. If, during the first taxable year beginning after July 1, 1986, S recognizes gain of $200 and it cannot be established that such gain is allocable to appreciation arising in periods after the acquisition of control, the premium account is reduced by $200 (to $300). If, instead, the amount of gain recognized by S were $600, the premium account would be reduced to zero, and the discount account would be $100. (Note that such gain recognition would also tend to increase S's net inside basis.)

In general, the applicable percentage of any loss recognized by the subsidiary during the three-year period shall reduce the discount account, but not below zero. To the extent the controlling corporate shareholder establishes that the loss is allocable to periods before the control date, the premium account is increased and the discount account is decreased. In the latter case, any decrease of the discount account below zero shall be credited to the premium account.

As noted, in the case of any taxable year after the third taxable year beginning after the control date, the balance in any premium or discount account shall be zero and no further adjustments need be made.

c. Control; stock—For purposes of section 1020, "control" has the same meaning as in section 366(c) (*i.e.,* generally, 80% vote and value). If more than one member of an affiliated group owns stock in the same corporation, control shall be determined by aggregating the interests of the members, and if the members own control, the stock interest of each member in the controlled subsidiary shall be subject to the section 1020 rules. "Stock" does not include stock described in section 1504(a)(4).

d. Disposition of stock—When stock of a controlled subsidiary is disposed of, an allocable portion (pro-rata by value) of the stock basis determined under section 1020 (taking into account a pro-rata portion of any premium or discount account) shall be allocated to such stock. If, as a result of such disposition, the corporate shareholder no longer owns control of the subsidiary, then the remaining basis determined under section 1020 (taking into account the balance in any premium or discount account) shall be allocated to the corporate shareholder's remaining stock in the subsidiary, and the premium and discount accounts shall no longer be maintained. Regulatory authority is provided to permit an exception to the above where the primary purpose of the disposition is tax avoidance.

e. Control date—As noted, the "control date" is generally the later of the date control is acquired or January 1, 1986. For example, assume that on January 1, 1986, P already owns 100% of S. Furthermore, assume that P's basis in its stock (determined without regard to section 1020) on that date is $100, and S's net inside basis is $125. P's basis in its S stock on January 1, 1986 would be equal to S's net inside basis ($125) less the discount account ($25) or $100.

Assume instead that P owns only 20% of S prior to January 1, 1986 (with basis of $200) and purchases an additional 60% of S on July 1, 1986 for $1000. Assume that on July 1, 1986, S's net inside basis is $900. The initial premium account would be $480 ($200 plus $1000 less (80 percent of $900)).

f. Effective date—New section 1020 shall take effect on January 1, 1986.

## SECTION 202—BASIS ADJUSTMENTS TO REFLECT CORPORATE LEVEL TAX PAID IN CERTAIN CORPORATE ACQUISITIONS AND LIQUIDATIONS

20. *Section 1060*—New section 1060 sets forth rules that provide an upward adjustment to the basis of a shareholder's stock in a small business corporation in the case of an acquisition or liquidation of that corporation. In general, the amount of the basis adjustment reflects the amount of the corporate level tax on long-held capital assets paid by the corporation in the transaction. As a result, in an acquisition, liquidation, or liquidating sale, gain on the disposition of a long-held capital asset that is subject to tax at the corporate level is not subject to tax at the shareholder level.

a. General rule—In the case of any section 1060 transaction involving a corporation (*i.e.*, a qualified acquisition of the corporation or a liquidation to which section 331 applies), the basis of an eligible shareholder's stock in the corporation is increased by the shareholder's pro-rata (by value of stock owned) share of the "aggregate basis adjustment," but not to exceed the fair market value of the stock. The term "aggregate basis adjustment" generally means (i) an amount equal to the "long-held capital asset tax" divided by 0.28 less (ii) the "long-held capital asset tax". This formula approximates the amount of gain, after taxes, realized by the corporation on its long-held capital assets.

The "long-held capital asset tax" is equal to the excess (if any) of (i) the taxes actually imposed on the corporation and any qualified subsidiary of the corporation during the disposition period (the 12-month period ending with the acquisition date or date of liquidation) over (ii) the taxes which would have been imposed on those corporations had no gain or loss been recognized on the disposition of a long-held capital asset (*i.e.*, one with a holding period of 5 years or more at the time of the disposition) during the disposition period. In making the latter computation, net section 1231 gains on long-held capital assets during the disposition period shall be taken into account only to the extent of the lesser of (i) the amount of such net gain, or (ii) the net section 1231 gains with respect to *all* property during the disposition period.

*EG(1):* Individual A owns all of the stock of corporation T, and T is completely liquidated. T's only asset is real property having a value of $11,000 and basis of $1,000. T has held the real property for over 5 years. A's basis in the stock of T is also $1,000. In this example, T's gain on the liquidation is $10,000 ($11,000 value less $1,000 basis) and its tax is $2,800. Had the gain on the real property not been recognized, T's tax would have been $0. Therefore, T's "longheld capital asset tax" is $2,800 and the aggregate basis adjustment is $7,200. A will realize and recognize no gain or loss in the liquidation ($8,200 – $8,200 = $0).

*EG (2):* In the above example, if A's basis in the T stock had been $5,000 before the liquidation, the adjustment to A's basis would have been only $3,200 (*i.e.,* up to the fair market value of the stock of T).

*EG (3):* Individual A owns all of the stock of corporation T, and T is completely liquidated. T's assets consist of four pieces of section 1231 property: A (value = $4,600, basis = $1,000, held over 5 years); B (value = $1,000, basis = $1,200, held over 5 years); C (value = $1,500, basis =$1,000, held 3 years); and D (value = $900, basis = $2,000, held 2 years). T also has some appreciated stock (value = $1,000, basis = $800, held 2 years). Assume A's basis in the stock of T is $6,000.

In this example, T's gain on the liquidation is $3,000 ($9,000 value less $6,000 total basis) and its tax is $840. In determining the amount of tax liability had no gain or loss been recognized on the disposition of long-held capital assets, the section 1231 gain taken into account is $2,800 (lesser of $3,400 or $2,800). Therefore, T's "long-held capital asset tax" is $784 ($840 less $56) and the aggregate basis adjustment is $2,016. A's gain on the liquidation is equal to $144 ($8,160 less $8,016).

For this purpose, a corporation is a "qualified subsidiary" of another corporation if the other corporation owned (or was treated as owning), immediately before the date of acquisition, stock in the subsidiary meeting the requirements of section 1504(a)(2), and, as a result of a qualified acquisition of the parent, the acquiring corporation made a qualified acquisition of the subsidiary. As noted, the term "long-held capital asset" means any capital asset with a holding period of at least 5 years at the time of disposition. Thus, goodwill will generally qualify as a long-held capital asset if the corporation has been in existence for at least 5 years.

b. Notification of basis adjustment—Notice of the basis adjustment shall be provided to each shareholder of the target or liquidating corporation who owned stock on the date of the acquisition or liquidation. The notice shall be provided by the acquiring corporation (in the case of a qualified acquisition) or the liquidating corporation within 60 days of the due date (determined with extensions) for filing the tax return of the target or liquidating corporation. The notice shall set forth the shareholder's pro-rata share of the aggregate basis adjustment (determined by reference to the amounts shown on the tax return of the target or liquidating corporations, or any qualified subsidiary), and any other information required by the Secretary. Failure to provide notice may result in a penalty under section 6678.

c. Imposition of tax if basis adjustment too large—If, after calculating the aggregate basis adjustment on the basis of the tax imposed on the target or liquidating corporations or any qualified subsidiary, it is determined the basis adjustment provided was too large, there is imposed on the target or liquidating corporations for the taxable year including the acquisition date or date of liquidation, an amount of tax equal to 20 percent of the excess basis adjustment. No credit shall be allowed against such tax. The tax shall be in addition to any other tax imposed. This provision may apply, for example, where a subsequent audit of the corporate tax return determines that the corporation initially overpaid its taxes, and therefore calculated an excessive aggregate basis adjustment.

d. Eligible shareholders; time of basis adjustment—The term "eligible shareholder" means any person who holds stock of the target or liquidating corporation on the acquisition date or date of liquidation, but only if the gain on the disposition of such stock would be long-term capital gain. If the gain would not be long-term capital gain, a prior holder of the stock may qualify as an eligible shareholder under two conditions. First, the prior holder must have disposed of the stock during the 6-month period ending with the acquisition date or date of liquidation. Second, gain on the disposition of such stock by the prior holder must have qualified as long-term capital gain.

In general, any basis adjustment shall be made as of the beginning of the acquisition date or date of liquidation. In the case where a prior holder of the stock is an "eligible shareholder," the basis adjustment shall be treated as having been made immediately before the prior holder disposed of the stock.

For purposes of this section, the term "stock" does not include stock described in section 1504(a)(4).

e. Eligible corporations—The basis adjustment rules apply fully to any corporation whose fair market value on the acquisition date or date of liquidation is $1 million or less. For corporations whose value is over $1 million, the aggregate basis adjustment is reduced (but not below zero) by 10 percent for each $100,000 by which the value exceeds $1 million. Thus, corporations over $2 million in value are not eligible for the basis adjustment rules.

The Secretary is authorized to disregard dispositions of stock or assets or any other transaction if the primary purpose of the transaction is to avoid the above limitation.

f. Effective date—New section 1060 shall apply to acquisitions and liquidations made after December 31, 1985.

## SECTION 211—NO GAIN OR LOSS RECOGNIZED ON EXCHANGE OF STOCK OF CONTROLLING CORPORATION

21. *Section 1032*—Under current law, no gain or loss is recognized by a corporation on the receipt of property in exchange for stock of such corporation. A corporation, however, may recognize gain or loss if it issues stock of another corporation (including a corporation in control of the issuing corporation) in exchange for property. Under the bill, section 1032 is amended to provide that

no gain or loss is recognized by a corporation on the receipt of property in exchange for stock of such corporation or a corporation owning (directly or indirectly under section 318(a)) control of the issuing corporation. For this purpose, section 318(a) is applied without regard to section 318(a)(3)(C) or 318(a)(4).

## SECTION 212—CHARACTER OF GAIN ON DISPOSITION OF CERTAIN PROPERTY BY CORPORATION DETERMINED BY REFERENCE TO SHAREHOLDERS

22. *Section 1257*—New section 1257 provides a "shareholder flavoring" rule for determining the character of gain at the corporate level on the disposition of certain property.

Under section 1257, if any corporation disposes of property to which the section applies during the "applicable period," then notwithstanding any other provision, gain from the disposition shall be treated as ordinary income. The section applies to both (1) property transferred to the corporation as a capital contribution the gain on which would be ordinary income if held by the contributing shareholder, and (2) property manufactured, constructed, produced, purchased or otherwise acquired by the corporation, the gain on which would, if held by one or more shareholders of the corporation holding a substantial portion of the stock of the corporation, be treated as ordinary income. The term "substantial portion" shall have the same meaning as under Treas. Reg. section 1.1375-1(d). The term "applicable period" refers to the 3-year period beginning with the date of the capital contribution or the date on which the holding period of the corporation with respect to the property, begins.

For purposes of this section, if a corporation is a member of an affiliated group (within the meaning of section 1504(a), but without regard to section 1504(b)), all members of the group shall be treated as one corporation.

*EG(1)*: Individual A, a dealer in real property, contributes a building to newly-formed corporation X in a section 351 transaction. Two years later, X is liquidated. X will recognize ordinary income on the liquidating distribution of the building to A. A will also recognize gain in the liquidation.

*EG(2)*: The same facts as in EG(1) above, except that X contributes the building to newly-formed subsidiary Y and, within 3 years of the capital contribution by A, Y disposes of the building. Y will recognize ordinary income on the disposition of the building.

## SECTION 213—AMENDMENT TO SECTION 1248

23. *Section 1248*—a. Special rule for qualified stock acquisitions—A foreign corporation's earnings and profits are increased to reflect gain realized in a qualified asset acquisition of the corporation for which a cost basis election is made. Under the bill, section 1248 is amended to accomplish the same result in a qualified stock acquisition of the foreign corporation. Thus, solely for purposes of computing the earnings and profits of a foreign corporation, section 1248 is amended to provide that in a qualified stock acquisition of the corporation for which a cost basis election is made, the deemed sale

and purchase of the foreign corporation's assets is treated as occurring immediately before the acquisition of stock.

b. Shareholder flavoring rule—A special rule similar to new section 1257 is provided in a case where 70 percent or more of the assets of a foreign corporation would be ordinary income property in the hands of certain shareholders of the corporation. In general, any gain on the sale or exchange of stock to which section 1248(a) would apply shall be treated as ordinary income if 70 percent of the assets of the corporation are assets to which section 1257 applies. For purposes of making the 70 percent computation, there shall not be taken into account any asset, the holding period of which in the hands of the foreign corporation is 3 years or more at the time of the disposition of stock.

### SECTION 214—MODIFICATIONS RELATING TO SUBCHAPTER S

24. *Sections 1367 and 1368*—Under current law, a "C" corporation that makes an "S" election may be able to avoid a corporate level tax on the appreciation in value of the corporation's assets while it was a C corporation. Current law section 1374 imposes a corporate level tax but only on certain gains realized within 3 years of the election.

a. General rule—Under the bill, no increase shall be made to the basis of any shareholder's stock in an S corporation with respect to 80 percent of the long-term capital gain and 50 percent of all other gain recognized by the S corporation on the disposition of its assets during the 5-year period beginning with the "transfer date." Except as provided below, the provision applies to any case where a corporation makes an S election, or where an S corporation makes a qualified asset acquisition (within the meaning of section 364(c)) of a C corporation which is a carryover basis acquisition. Any gain to which the general rule applies shall not be taken into account for purposes of section 1374.

The general rule does not apply to gain on the disposition of a capital asset or section 1231 property if the holding period of the property in the hands of the S corporation at the time of disposition is 5 years or more. In addition, the general rule does not apply to gain (1) that the S corporation establishes is allocable to periods during which the S election was in effect (*e.g.*, gain on property held by the S corporation before the qualified asset acquisition, or gain arising after the transfer date); or (2) that, when added to gain on any prior disposition to which the general rule applies, exceeds the built-in gain immediately before the transfer date. The term "built-in gain" means the excess of the fair market value of the assets of the C corporation immediately before the transfer date over the aggregate adjusted basis of such assets at that time. The term "transfer date" means the date the S election takes effect or, in the case of a qualified asset acquisition, the acquisition date.

*EG (1):* Individual A owns all of the stock of corporation X, a "C" corporation. X makes an election to be an "S" corporation, effective January 1, 1988. During 1988, X has $300 in long-term capital gain. Assume none of the exceptions applies. In this example, the gain of X in 1988 results in a $60 increase to A's basis in the stock of X.

b. Modification of accumulated adjustments account—In general, adjustments to the accumulated adjustments account (AAA) are conformed to those set forth in section 1367 (see section 1368(e)(1)). Under the bill, any gain that does not result in an increase to a shareholder's stock basis by reason of the general rule described above shall, five years after the transfer date, increase the AAA account.

c. Applicable corporations—The Subchapter S modifications do not apply to any corporation whose fair market value immediately before the transfer date is $1 million or less. For corporations whose value is over $1 million, the impact of the S corporation changes is phased-in. For each $100,000 over $1 million, 10 percent of the gain described in the general rule shall be taken into account, but not to exceed 100 percent. Thus, the Subchapter S modifications are fully in effect for corporations over $2 million in value.

Any corporation that is not subject to the Subchapter S modifications, in whole or in part, may elect to be subject to these modifications.

## SECTION 215—EFFECTIVE DATES

25. *Effective Dates*—The amendments made to sections 1032, 1248, and new section 1257 shall apply to dispositions made after December 31, 1985, in taxable years ending after such date. The amendments made to sections 1367 and 1368 shall apply to elections under section 1362 made after December 31, 1985, and to acquisitions after December 31, 1985.

## SECTIONS 301 AND 302—LIMITATIONS ON TAX CARRYOVERS

26. *Section 382*—Under the bill, new sections 382, 382A, and 383 provide rules limiting the use of net operating loss carryovers and other carryforwards after there has been a substantial change in control of a corporation. As a general proposition, the rules operate to limit the amount of taxable income after the change in control that may be offset by losses arising prior to the change. The limitation each year is generally equal to the value of the corporation at the time of the change multiplied by the applicable Federal long-term rate. The rules supercede and replace both the 1954 and 1976 versions of sections 382 and 383, which would be repealed.

a. General rule—Under the general rule, in the case of any ownership change (as defined in section 382A) of any old loss corporation, the amount of the taxable income of the new loss corporation for any post-change year which may be offset by one or more prechange losses shall not exceed the section 382 limitation for such year. The terms "old loss corporation" and "new loss corporation" refer to the corporation entitled to use a net operating loss carryover, an excess credit carryover, or a capital loss carryover, before and after the ownership change, respectively. The term "prechange loss" refers to (1) the net operating loss of the old loss corporation for the taxable year in which the change occurs which is allocable (determined on a pro rata basis) to the period in such year up to the date of the change, (2) any net operating loss for any prior taxable year, and (3) any "recognized built-in loss." The term "post-change year" refers to any taxable year ending after the date of the change.

The "section 382 limitation" for any post-change year is an amount equal to the sum of (1) the value of the stock of the loss corporation (including any stock described in section 1504(a)(4)) immediately before the change multiplied by the Federal long-term rate under section 1274(d) as of the date of the change; (2) the "recognized built-in gain" for the post-change year; and (3) the amount of any carryover of any unused section 382 limitation to such post-change year. (The purchase price of a substantial portion of the stock of the loss corporation will ordinarily be indicative of the value of the stock of the loss corporation.) If the section 382 limitation exceeds the taxable income of the loss corporation which is offset by pre-change losses, the excess shall be carried over and shall increase the section 382 limitation for the succeeding taxable year.

These basic rules may be illustrated by the following example.

*EG(1):* Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1986, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L was $500,000 and the Federal long-term rate under section 1274(d) was 12 percent. Finally, L incurred a net operating loss during 1986 of $100,000, and L had no built-in gains or losses.

Under these facts, the taxable income of L after July 1, 1986, that could be offset by L's losses prior to July 1, 1986, would generally be limited. In particular, for all taxable years after 1986, the pre-change losses of L could be used to offset no more than $60,000 of L's taxable income each year. (For the amount of the limitation for taxable year 1986, see below.) The "pre-change losses" of L would constitute the $1 million of net operating loss carryforwards plus one-half of the 1986 net operating loss, or a total of $1,050,000. If, in taxable year 1987, L had only $30,000 of taxable income to be offset by L's pre-change losses, then the amount of L's 1988 taxable income that could be offset by pre-change losses would be limited to $90,000 ($60,000 annual limit plus $30,000 carryover).

A special rule is provided for determining the amount of the limitation for the taxable year that includes the date of the change. In that case, the section 382 limitation shall be equal to the sum of the pro-rata portion (based on the number of days in the year following the change) of the section 382 limitation (determined without regard to the special rule) plus the pro-rata portion (based on the number of days in the year up to and including the change) of the taxable income for the year. This rule allows income attributable to the period up to the time of the ownership change to be offset by carryovers without the application of any limitation. In addition, the rule computes the proportionate part of a full year's limitation that should apply to the portion of the year following the ownership change. Thus, in example (1), assume that L had taxable income of $100,000 in 1986 instead of a net operating loss. In that case, L's 1986 taxable income that could be offset by pre-change losses would be limited to $80,000 (1/2 × $60,000 plus 1/2 × $100,000).

b. Ordering rules—The bill retains the current law ordering rules set forth in section 172 which determine the order by which losses arising in different years may be utilized. In addition, the bill provides a special ordering rule in a case where the use of pre-change losses arising in a particular year are subject to limitation under section 382, while the use of other losses arising in the same year are not subject to limitation. In general, the ordering rule provides that the losses subject to limitation shall be used prior to losses not subject to limitation.

*EG(2):* On January 1, 1986, all of the stock of corporation L, a calendar year taxpayer, is sold in a transaction constituting an ownership change of L. On that date, L has $500,000 of unused net operating loss carryforwards from 1985. Assume that the section 382 limitation is $150,000 per year. Further, assume that L has no built-in gains or losses, and that L has a loss of $300,000 in 1986 and taxable income (before application of any net operating loss deduction) of $200,000 in 1987.

In this example, the 1985 loss is used first to reduce L's taxable income in 1987. However, the section 382 limitation only permits the loss to be used to offset $150,000 of 1987 taxable income. The remainder of the 1985 loss is carried forward for use subsequent to 1987. The remaining $50,000 of taxable income in 1987 may be offset by the 1986 loss. As a result, after application of the net operating loss deductions, L has no taxable income in 1987 and has $350,000 of net operating loss carryovers from 1985 and $250,000 of carryovers from 1986.

*EG(3).* In 1986, corporation A merges into corporation B, with B surviving, in a transaction that constitutes an ownership change to A. Both A and B had net operating losses arising in 1982 that are to be carried forward to 1987. A's losses constitute "pre-change losses," and therefore the use of such losses in 1987 are subject to the section 382 limitation. B's losses are not subject to limitation. Based on the ordering rule, A's losses shall be fully utilized first (up to the applicable section 382 limitation), and then B's losses may be utilized.

c. Built-in gains and losses—As noted, a "recognized built-in loss" is treated as a "pre-change loss," and is therefore subject to limitation. A "recognized built-in gain" operates to increase the amount of the section 382 limitation.

Under the bill, the terms "recognized built-in gain" and "recognized built-in loss" generally mean the amount of gain (or loss) recognized during any taxable year within the "recognition period" (*i.e.*, that portion of the first post-change year including or following the ownership change, and the next succeeding four taxable years) on the disposition of any asset to the extent the gain (or loss), when added to the recognized built-in gain (or recognized built-in loss) for any preceding taxable year within such period, does not exceed the built-in gain (or built-in loss) of the old loss corporation. Gain shall be treated as recognized built-in gain, however, only to the extent the taxpayer establishes the gain is allocable to any period before the ownership change. Further, loss shall be treated as recognized built-in loss except to the extent the taxpayer establishes that the loss is allocable to any period after the ownership change.

The terms "built-in gain" and "built-in loss" generally mean, with respect to any old loss corporation, the amount by which the fair market value of the assets of the corporation immediately before the ownership change is more or less, respectively, than the aggregate adjusted basis of the assets as of such time. A threshold test is provided which serves to disregard any built-in gain or built-in loss if such gain or loss (determined without regard to the threshold test) is not greater than 25 percent of the fair market value of the assets of the corporation immediately before the ownership change. In computing built-in gain and built-in loss, cash, cash items, and Government securities with a maturity (at issue) of less than three years (*i.e.*, items with insignificant appreciation or depreciation in value) shall be disregarded.

Finally, the Secretary is authorized to provide regulations that treat as built-in losses any amount accruing before the date of the change but which is allowable as a deduction on or after the change. This provision generally is intended to apply to items that accrue and would be deductible prior to the change but for some provision in the law (*e.g.*, section 267). The Secretary should consider to what extent the regulations should also apply to built-in depreciation deductions.

The built-in gain or loss provisions may be illustrated my the following examples. Assume in all cases that L corporation (a calendar-year taxpayer) has an ownership change on July 1, 1986, and that the change does not terminate L's taxable year.

*EG(4)*: On July 1, 1986, the aggregate value of the non-cash assets of L is $100 and the aggregate adjusted basis of those assets is $120. L has a built-in loss of $20, which is less than 25% of the value of its non-cash assets (*i.e.*, $100). Therefore, L's built-in loss is disregarded, and any gains or losses of L after the change will not be treated as recognized built-in gains or losses.

*EG(5)*: On July 1, 1986, the aggregate value of L's non-cash assets is $1,100 and the aggregate adjusted basis of those assets is $2,000. L's built-in loss of $900 exceeds the threshold amount. During each of the taxable years 1987, 1988, and 1989, L recognizes losses totaling $400. The losses in 1987 and 1988, and $100 of the loss in 1989, will be recognized built-in losses subject to the section 382 limitation, except to the extent L can establish that the losses accrued during the period after July 1, 1986.

d. Successive changes—Two special rules apply in the case of successive ownership changes. First, if the section 382 limitation with respect to the second change ("second limitation") is less than or equal to the section 382 limitation with respect to the first change ("first limitation"), then the second limitation shall apply to all pre-change losses, and the first limitation shall be disregarded.

If the second limitation is greater than the first limitation, both limitations shall apply concurrently. However, the amount of the second limitation shall be reduced by the amount of taxable income which is offset as a result of the first limitation. In this case, the second limitation shall apply only to losses arising subsequent to the first change. The use of losses arising prior to the first change would continue to be limited by the first limitation. Any losses recognized during the interim period between the two changes which were treated as "recognized built-in losses" with respect to the first change, would be limited by the first limitation, and not by the second limitation. Any gains or losses recognized after the second change would not be treated as "recognized built-in gains" or "recognized built-in losses" with respect to the first change, even though occurring within the recognition period for that change, but may be treated as "recognized built-in gains" or "recognized built-in losses" with respect to the second change.

*EG(6):* There is an ownership change of L on January 1, 1987, and on January 1, 1989. The section 382 limitation with respect to the first change is $150 per year, and the section 382 limitation with respect to the second change is $100 per year. In this example, any pre-change losses with respect to the second change (including losses arising prior to 1987) would be subject to the $100 per year limitation for 1989 and beyond. The $150 per year limitation would no longer be in effect as to the use of losses in 1989 or beyond.

*EG(7):* Same facts as EG(6) except that the section 382 limitation with respect to the first change is $40 per year.

In this example, any losses of L arising prior to 1987, as well as any losses arising in 1987 and 1988 that are treated as "recognized built-in losses", could be used to offset only $40 of taxable income of L per year beginning with 1987. Any losses of L arising in 1987 and 1988 that are not treated as recognized built-in losses with respect to the first change, and any losses arising after 1988 that are treated as "recognized built-in losses" with respect to the second change, could be used to offset $60 of taxable income of L per year beginning in 1989 so long as $40 of taxable income of L each year were offset by losses subject to the first limitation.

e. Special rule for certain capital contributions—Under the bill, any capital contribution received by the old loss corporation as part of a plan the principal purpose of which is to avoid any limitation under section 382 shall not be taken into account for purposes of the section. This provision may apply to disregard, for example, (1) a capital contribution for the principal purpose of increasing the value of the loss corporation in order to increase the amount of the section 382 limitation, (2) a capital contribution of appreciated property for the principal purpose of reducing or eliminating the amount of built-in loss of the corporation; or (3) a cash contribution for the principal purpose of reducing the amount of built-in loss below the threshold amount. The term "capital contribution" is to be interpreted broadly to encompass any direct or indirect infusion of capital into the loss corporation.

Except as provided in regulations, any capital contribution made within 2 years of the date of the change shall presumptively be treated as part of a plan, the principal purpose of which is to avoid a limitation under section 382. Accordingly, except as provided in regulations, all such contributions shall be disregarded for purposes of section 382. It is anticipated that the regulations may except contributions made necessary to continue the basic operation of the corporation's business (*e.g.,* to meet the monthly payroll needs of the corporation).

*EG(8):* Corporation X merges into corporation Y, with Y surviving, and assume that the merger is an ownership change of X. X, however, has no carryovers. At the time of the merger, the value of

X was $500,000. Finally, within 2 years of the merger, there is an ownership change of Y.

In this example, the merger would constitute a "capital contribution" by X to Y of $500,000, which took place within 2 years of the subsequent ownership change of Y. Accordingly, except as provided in regulations, the value of Y at the time of the ownership change would be reduced by $500,000 for purposes of section 382.

The same result would apply even if X had carryovers which were limited after the initial merger. In that case, however, the ownership charge of Y would be a second change of the same corporation, and the special rule for successive changes would apply.

f. Special rule for investment companies—If, immediately before the ownership change, the old loss corporation is an "investment company," the section 382 limitation shall be zero. Thus, in that case, there would be no carryover of the old loss corporation's net operating losses.

For this purpose, "investment company" is defined as any corporation if at least ⅔ of the value of the total assets of the corporation consists of assets held for investment. Assets that are used in an active trade or business and assets that are temporarily not being used, but were formerly used in an active business, are not assets held for investment. However, assets held in an investment business, regardless of how actively used, would constitute assets held for investment. The term "investment company" does not include a regulated investment company or a real estate investment trust.

In determining whether a corporation is an investment company, stock and securities held by a parent corporation in a subsidiary shall be disregarded, and the parent is treated as owning its ratable share of the subsidiary's assets. For this purpose, a corporation is a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of shares of all classes of stock outstanding.

It is anticipated that in determining whether a corporation is or is not an investment company, the step transaction doctrine will generally apply. For example, assume that 50 percent of a corporation's assets are held for investment. The corporation has agreed to dispose of its non-investment assets. To avoid the investment company limitation, the corporation delays disposing of its non-investment assets until just after an ownership change of the corporation. In that case, the step transaction doctrine may apply to collapse the steps, thereby resulting in the corporation being treated as an investment company immediately before the change.

g. Special rule for Title 11 or similar cases—Under the bill, there shall be no limitation on the use of net operating loss carryovers after an ownership change of certain corporations which are under the jurisdiction of a court in a Title 11 or similar case immediately before the change. This rule applies only if the shareholders and creditors of the corporation immediately before the change own, immediately after the change, stock of the new loss corporation meeting the requirements of section 1504(a)(2) (substituting "50 percent" for "80 percent" in that section).

If the above rule applies, then the net operating loss deduction of the new loss corporation under section 172(a) for any post-change year shall be determined as if no deduction were allowable for interest paid or accrued by the old loss corporation during the 3 taxable years preceding the taxable year in which the change occurs with respect to any indebtedness which is converted into stock pursuant to the Title 11 or similar case. This rule is based on the notion that the creditor's interest prior to the change was, in reality, an equity interest and, therefore, payments made to the holder of the interest should not be deductible by the corporation.

Furthermore, if a second ownership change were to occur with respect to the same corporation within two years of the first change, the section 382 limitation with respect to the second change would automatically be zero. This rule simply confirms that because the value of the loss corporation at the time of the first change was presumably zero, and any capital contributions during the two years prior to the second change are generally disregarded. The value of the corporation at the time of the second change is still zero. Thus, no net operating loss carryovers would survive the second change of ownership.

h. Other definitions—"Taxable income" shall be computed with the modifications set forth in section 172(d). The term "value" refers to fair market value.

i. Interaction with other sections—The bill amends section 269 so that it will not apply to disallow the deduction for any loss or the claiming of any credit to which section 382 or 383 applies. Accordingly, the carryovers of any corporation after an ownership change (as defined in section 382A) will not be limited by the application of section 269 to the transaction. In addition, the *Libson Shops* doctrine will not apply to any such acquisition. The Secretary is also directed to consider to what extent the separate return limitation year (SRLY) and consolidated return change of ownership (CRCO) rules should be modified in view of the changes to sections 382 and 383.

j. Effective date—Sections 382, 382A, and 383 would apply to changes in ownership occurring in taxable years beginning after December 31, 1985. Current law would remain in effect until then. No "testing period" (as defined in section 382A(e)) shall begin before January 1, 1986.

27. *Section 382A*—As noted, section 382 generally provides a limitation as to the use of net operating loss carryovers after an "ownership change" of a loss corporation. Under the bill, new section 382A provides rules defining "change" and "ownership change." "Change" and "ownership change" mean a "more than 50-percent owner shift" or a "more than 50-percent equity structure change" in a qualified asset acquisition.

a. "More than 50-percent owner shift"—There is a "more than 50-percent owner shift" if, immediately after any owner shift, the aggregate total value of the stock of the old loss corporation held (or treated as held) by all 5-percent shareholders has increased or decreased by more than 50 percentage points over such holdings by such shareholders at any time during the testing period. The term does not include a "more than 50-percent equity structure change." An "owner shift" means any change in the respective holdings in the stock of a corporation. The "testing period" is generally the 3-year period prior to the owner shift or the qualified asset acquisition for which the determination is being made. The term "5-percent shareholder" means any person holding (or treated as holding) at any time during the testing period, 5 percent or more of the value of the stock of any corporation.

The following examples illustrate these rules.

*EG (9):* On January 1, 1987, L corporation is publicly-held, with no shareholder owning as much as 5 percent of its stock. On September 1, 1987, individuals A, B, and C, who were not previously shareholders of L and are unrelated to any such shareholders, each acquires one-third of the stock of L. Immediately after such date, A, B and C are each 5-percent shareholders of L who, in the aggregate, have increased their holdings by over 50 percentage points from what they held at any point during the 3 years prior to September 1, 1987. Therefore, there has been an ownership change of L by reason of a more than 50 percent owner shift.

*EG (10):* On January 1, 1987, L is wholly-owned by X. On January 1, 1988, X sells 50 percent of his stock to 1000 shareholders unrelated to him, no one of whom acquires as much as 5 percent of the stock of L. On January 1, 1989, X sells his remaining 50 percent interest to an additional 1000 shareholders unrelated to him. Based on these facts, as of January 1, 1988, there has not been a "more than 50 percent owner shift." However, on January 1, 1989, there is an ownership change of L because as of that date, X has decreased by more than 50 percentage points his stock holding in L from what he held at any point during the prior 3 years

*EG(11):* On January 1, 1987, L is a publicly-held corporation with no shareholder owning 5 percent or more of its stock. During the next two years, the stock of L is actively traded, and by January 1, 1989, those persons who are shareholders of L held, in the aggregate, only 10 percent of the stock of L on January 1, 1987. At no point during the two-year period, however, has any shareholder owned as much as 5 percent of the stock of L. Based on these facts, there has not been a "more than 50 percent owner shift" of L.

It is intended that the term "owner shift" be interpreted broadly to incorporate any change in the respective holdings in the stock of a loss corporation, however effected. For example, a "more than 50-percent owner shift" may result from a purchase or exchange of stock, the issuance of new stock, redemptions, recapitalizations, the conversion of nonparticipating preferred stock into participating stock, or any combination of the foregoing.

This may be illustrated by the following:

*EG(12):* On January 1, 1987, X owns all 1000 shares of corporation L. On June 15, 1987, he sells 300 of his L shares to A. On January 15, 1988, L issues 100 shares to each of B, C, and D. On December 15, 1988, L redeems 200 shares owned by X. Based on these facts, there is an ownership change of L on December 15, 1988.

*EG(13):* On January 1, 1987, A owns 50 shares of common stock of L and 1000 shares of nonvoting preferred stock of L which meets the requirements of section 1504(a)(4). (As described below, for purposes of these provisions, the term "stock" does not include stock described in section 1504(a)(4).) B owns 450 shares of L common stock. On December 10, 1989, the nonvoting preferred stock is converted into voting preferred stock. At that time, the value of the preferred stock is equal to the value of the L common stock. Based on these facts, there has been an ownership change of L on December 10, 1989.

b. "More than 50-percent equity structure change"—There is a "more than 50-percent equity structure change" if, immediately after a qualified asset acquisition (as defined in section 364(c)), the total value of the stock of the new loss corporation held (or treated as held) by shareholders of the old loss corporation is more than 50 percentage points less than the total value of the stock of the old loss corporation held (or treated as held) by such shareholders at any time during the testing period.

The Secretary is authorized to prescribe regulations in cases where the shareholders of the old loss corporation own stock of the new loss corporation meeting the requirements of section 1504(a)(2) (substituting "50 percent" for "80 percent" in that section) immediately after a qualified asset acquisition.

*EG(14):* On January 1, 1988, L corporation is merged into P corporation, with P surviving. Both L and P are publicly-traded corporations with no shareholder owning as much as 5 percent of either corporation or of the surviving entity. In the merger, the former shareholders of L receive 30 percent of the stock of P, and the remaining stock of P is owned by shareholders unrelated to the former shareholders of L. There has been an ownership change of L. If, in the merger, the former shareholders of L receive 70 percent of the stock of P, there has not been an ownership change of L. However, under regulations, the transaction may be treated as an ownership change of P.

It is anticipated that a "more than 50-percent equity structure change" may result from a combination of an owner shift followed by a qualified asset acquisition, or a series of qualified asset acquisitions. In addition, it is expected that the step transaction doctrine would apply to determine whether a qualified asset acquisition followed by an owner shift should be treated as a "more than 50-percent equity structure change."

*EG(15):* On January 1, 1987, corporation X owns 100 percent of corporation L. On January 1, 1988, L is merged into corporation P, with X receiving 60 percent of the stock of P in the merger. On March 1, 1988, P is merged into Q, with X receiving 40 percent of the stock of Q. The remaining shareholders of Q are unrelated to X. Based on these facts, the second merger, but not the first merger, is an ownership change of L. (Under regulations, the first merger may be an ownership change of P.) Immediately after the second merger, the total value of the stock of Q held by X is more than 50 percentage points less than the total value of the stock of L held by X during the 3-year period prior to the second merger.

*EG(16):* L is a publicly-traded corporation with no shareholder owning 5 percent or more of its stock. On January 1, 1987, L merges into P, with P surviving, and in the merger, the former shareholders of L obtain 60 percent of the stock of P. Subsequent to the merger, the former shareholders of L sell 15 percent of their stock in P to the remaining P shareholders. At no time does any shareholder own as much as 5 percent of the stock of P.

In this example, the sale of P stock subsequent to the merger does not constitute a "more than 50 percent owner shift" because at no time has any shareholder owned as much as 5 percent of the stock of either P or L. However, the step transaction doctrine may operate to collapse the two transactions. In that case, the merger will be treated as an ownership change of L (and not an ownership change of P).

c. Constructive ownership—In determining ownership of stock, section 318 shall apply, except that (1) neither section 318(a)(2)(C) (attribution *from* corporations) nor section 318(a)(3)(C) (attribution *to* corporations) shall be applied with the 50-percent limitation contained therein, (2) paragraph 318(a)(3)(C) shall be applied with a pro-rata rule, and (3) section 318(a)(4) (option attribution) shall not apply.

*EG(17):* Corporation B owns 100 percent of the stock of corporation L. Corporation C owns 100 percent of the stock of corporation P. Corporation A owns 80 percent of each of B and C. On January 1, 1988, L merges into P, with P surviving, and B is completely cashed out. The transaction is not an ownership change of L. Before the merger, B owned 100 percent of L. After the merger, B indirectly owns 64 percent of L. (B is treated as owning 80 percent of the stock owned by A; A is treated as owning 80 percent of P; therefore, B indirectly owns 64 percent of P.) Therefore, the total value of stock of P treated as owned by the former shareholders of L is not more than 50 percentage points less than the total value of the stock of L owned by the former L shareholders.

*EG(18):* Corporation A owns all of the stock of corporation L, and X owns all of the stock of A. On January 1, 1987, Y acquires all of the stock of A from X. Y is not related to X. Based on these facts, there is an ownership change of A. In addition, there is an ownership change of L. In the latter case, after application of the constructive ownership rules, Y is treated as owning 100 percent of the stock of L after the acquisition, which is more than 50 percentage points over Y's ownership of L at any point during the testing period.

d. Other special rules relating to stock—Certain acquisitions of stock shall not be taken into account in determining whether an ownership change has occurred. These include: (1) an acquisition of stock by any person (a) the basis of which is determined under section 1014 or section 1015, (b) in satisfaction of a right to receive a pecuniary bequest, or (c) pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)); or (2) the acquisition of employer securities (within the meaning of section 409(1)) by (a) a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7)), or (b) a participant of any such plan pursuant to the requirements of section 409(h).

In addition, under regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.

e. Testing period; date of change—As noted, the "testing period" is generally the 3-year period ending on the day before the owner shift or qualified asset acquisition for which the determination is being made. The date of the change is (1) in the case of a "more than 50 percent owner shift," the date on which the owner shift occurs, and (2) in the case of a "more than 50-percent equity structure change," the acquisition date (within the meaning of section 366(a)(2)(B)). In two circumstances, the testing period may be less than a 3-year period. First, the testing period shall not begin before the first day following the testing period for any earlier change. This rule would shorten the testing period where there has been an ownership change within three years of an owner shift or a qualified asset acquisition.

Second, the testing period shall not begin before the first day of the first taxable year from which there is a carryover to the first post-change year. Under this rule, the testing period does not start until there is a year involving a loss or credit that would potentially carry over to periods following the ownership change.

f. Other rules—The term "stock" shall not include any preferred stock described in section 1504(a)(4). The Secretary is authorized to provide regulations as may be necessary to implement the purposes of the statute (1) by treating, in appropriate cases, warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock, and (2) by treating, in appropriate cases, options to acquire or sell as having been exercised. It is anticipated that any such regulations would have prospective effect only. Determinations of the percentage of stock of any corporation held by any person shall be made on the basis of value.

28. *Section 383*—Under the bill, section 383 generally provides limitations similar to section 382 as to the use of excess credits, capital loss carryovers, and foreign tax credit carryovers after a substantial change of ownership of a corporation has occurred. Present law section 383 is repealed.

a. Excess credits—In any case to which section 382(a) applies, under regulations, the amount of the tax liability of the new loss corporation for any post-change year which may be offset by one or more pre-change excess credits shall not exceed the tax liability attributable to that portion of the taxable income for the post-change year equal to the excess (if any) of (1) the section 382 limitation for the post-change year, less (2) the amount of pre-change loss taken into account (after application of section 382) in determining the amount of the taxable income for the year.

The term "pre-change excess credit" includes (1) any excess credit of the old loss corporation for the taxable year in which the change occurs which is allocable (determined on a pro-rata basis) to the period in such year up to the date of the change, and (2) any excess credit for any preceding taxable year. The term "excess credit" means any unused general business credit under section 39, and any unused credit under section 30(g)(2).

*EG(19)*: Assume that there is an ownership change of L (a calendar year taxpayer) on January 1, 1987, and the section 382 limitation is $100,000/year. Assume that L has $50,000 of pre-change losses, and $200,000 in pre-change excess credits. Finally, assume that L has taxable income (determined before any net operating loss carryovers) of $200,000 in 1987, and that L is in the 46% tax bracket. L may offset its taxable income with all $50,000 of its pre-change losses. In addition, the remaining section 382 limitation (*i.e.*, $50,000) produces a tax liability of $23,000 ($50,000 x 46 percent), so L may utilize $23,000 of its pre-change excess credits. As a result, L's tax liability for 1987 is $46,000, and L may carry forward excess credits of $177,000 into 1988.

b. Net capital losses—In any case to which section 382(a) applies, the amount of the taxable income of the new loss corporation for any post-change year which may be offset by one or more pre-change capital losses (including capital losses recognized on or after the change which are allocable to periods before the change) shall be limited under regulations based upon the principles applicable under section 382 and section 382A. The regulations shall provide that any pre-change capital loss used in a post-change year shall reduce the amount of any pre-change net operating loss which may be used in the post-change year. In other words, the use of pre-change capital losses in a post-change year shall have priority over the use of pre-change net operating losses.

The term "pre-change capital loss" means (1) any capital loss of the old loss corporation for the taxable year of the change which is allocable (determined on a pro-rata basis) to the period of the year up to the date of the change, and (2) any capital loss for any preceding taxable year.

c. Foreign tax credits—In any case to which section 382(a) applies, the amount of any excess foreign taxes under section 904(c) for any period before the ownership change shall be limited under regulations.

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